

MITIGATING SYSTEMIC RISK THROUGH WALL STREET REFORMS

HEARING

BEFORE THE

COMMITTEE ON

BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

ONE HUNDRED THIRTEENTH CONGRESS

FIRST SESSION

ON

EXAMINING THE AGENCIES' IMPLEMENTATION OF WALL STREET
REFORMS

JULY 11, 2013

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THURSDAY, JULY 11, 2013

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 11:02 a.m., in room SD-538, Dirksen Senate Office Building, Hon. Tim Johnson, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. Good morning. I call this hearing to order.

Today, the Committee continues its oversight of the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The officials before us today have been asked to update the Committee on their agencies' efforts to improve financial stability and mitigate systemic risk. This includes strengthening risk-based capital liquidity and leverage rules for our Nation's largest banks, enhancing risk management, facilitating the orderly resolution of any failing financial firm, and finalizing the Volcker Rule and other pending rules. These are important efforts to help realize the goals of Wall Street Reform.

Recently, significant progress has been made. In the past 2 weeks, the Fed, FDIC, and OCC finalized the Basel III capital rules and issued a proposal to reduce leverage at the largest firms. The FSOC also tagged certain financial companies for heightened supervision.

I also want to commend the agencies for working to strike the right balance in the rule-writing process and for taking steps to address concerns Ranking Member Crapo and I raised in our February letter regarding the treatment of community banks and insurance companies. New rules should focus on reducing risk, not applying a one-size-fits-all approach to a diverse marketplace.

While progress has been made, it has been nearly 5 years since reckless financial firms put our economy in jeopardy and 3 years since the passage of the Wall Street Reform Act. It is time to finish implementing these reforms as quickly as possible to put an end to "too big to fail" and to protect American taxpayers from ever again bailing out a failing financial company.

I have asked our witnesses to outline when their agencies will finalize the remaining rules required by the Act.

Congress must also do its job by confirming well-qualified nominees and providing funding to allow regulators to write and enforce the rules. Only then will we have a regulatory system that is ready

to identify and respond to the greatest risk to our Nation's economic well being.

I now turn to Ranking Member Crapo for his opening statement.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you, Mr. Chairman.

Today, we have asked our regulators to address the implementation of Title I and Title II of the Dodd-Frank Act. Title I of Dodd-Frank brought us the Financial Stability Oversight Council, heightened prudential standards, increased leverage and risk-based capital requirements, while Title II established a new system for resolution of systemically important nonbank financial companies.

The U.S. banking system and capital markets must remain the preferred destination for investors throughout the world. It is important that the implementation of capital standards and orderly liquidation are done properly without overburdening our financial system and without placing the United States markets at a competitive disadvantage.

In the past couple of weeks, the Federal banking regulators have been very busy, issuing a number of rules and guidance regarding capital standards. And very recently, the Federal Reserve, the OCC, and the FDIC issued final rules strengthening the regulatory capital framework for banking organizations, including Basel III. And as the Chairman indicated, earlier this year, he and I sent a letter regarding potential effects of Basel III proposals on community banks and insurance entities. So I also appreciate the distinctions made by the regulators in the final rules for these banks and insurers.

With regard to the overall capital standards and whether Dodd-Frank ended too big to fail, I look forward to hearing from the regulators on these issues today. I appreciate the hard work that has gone into these capital standards and into producing and reviewing living wills. But many, including myself, believe that Dodd-Frank did not yet end too big to fail.

Going forward, we must learn more about the additional steps that regulators plan to undertake to determine leverage and debt-to-equity ratios for big banks as well as how to treat short-term wholesale funding. It also remains to be seen whether and how orderly liquidations are able to address dissolution of systemically important nonbank financial companies while avoiding financial shocks to the market.

As we approach Dodd-Frank's third anniversary, there is a considerable amount of work to be done, such as working through the complexity of the Volcker Rule and issuing the outstanding risk retention rules.

Encouragingly, there does appear to be a building bipartisan consensus that some elements of Dodd-Frank may need to be fixed. At the last Humphrey-Hawkins hearing, Chairman Bernanke identified the end user exemption, the swap push-out, and community bank matters for relief in which specific Dodd-Frank provisions could be reconsidered.

At our recent hearing on community banks, it became clear that both sides of the aisle agreed that there is a need to provide relief to community banks, especially in rural areas. The regulatory

framework that emerged out of Dodd-Frank has made it increasingly difficult for community banks as they are disproportionately affected by the increased regulation because they are less able to absorb the additional costs.

In the brevity of time, so that we can get to the panel quickly, I also wish to reiterate the points that I have made at other hearings this year about the potential for cumulative regulatory burdens and the drain to our financial system by the necessity of well-prepared economic analysis and how these rules will affect our economy as a whole and may affect our global competitiveness. It is my hope that today's hearing will also allow us to address the critical and needed Dodd-Frank reforms as a bipartisan consensus grows that we can fix at least some of these issues.

Thank you, Mr. Chairman.

Chairman JOHNSON. Thank you, Senator Crapo.

This morning, opening statements will be limited to the Chairman and Ranking Member to allow more time for questions from the Committee Members. I want to remind my colleagues that the record will be open for the next 7 days for opening statements and any other materials you would like to submit.

Now, I would like to introduce our witnesses. Mary Miller is the Under Secretary for Domestic Finance of the U.S. Department of the Treasury. Dan Tarullo is a member of the Board of Governors of the Federal Reserve System. Martin Gruenberg is the Chairman of the Federal Deposit Insurance Corporation. And Tom Curry is the Comptroller of the Currency.

I thank all of you again for being here today. I would like to ask the witnesses to please keep your remarks to 5 minutes. Your full written statements will be included in the hearing record.

Under Secretary Miller, you may begin your testimony.

**STATEMENT OF MARY J. MILLER, UNDER SECRETARY FOR
DOMESTIC FINANCE, DEPARTMENT OF THE TREASURY**

Ms. MILLER. Chairman Johnson, Ranking Member Crapo, and Members of the Committee, thank you very much for the opportunity to testify today.

I would like to update the Committee on several important regulatory developments since I appeared before you in February.

In April, the Financial Stability Oversight Council released its 2013 Annual Report, and in May, Secretary Lew testified before this Committee on the report.

At the beginning of June, the Council voted to make proposed designations of an initial set of nonbank financial companies under Section 113 of the Dodd-Frank Act. Earlier this week, the Council made final designations of two companies in this initial set that did not request hearings, American International Group and General Electric Capital Corporation. One other company currently subject to a proposed designation requested a hearing, which will be held no later than early August, with a final decision by the Council no later than the beginning of October. This is an ongoing process and the Council will continue to evaluate other companies for potential designation.

The bank regulatory agencies have just finalized an important set of rules codifying the Basel capital requirements for banks and

bank holding companies. They also proposed a leverage requirement earlier this week as a companion to the capital requirements. I will defer to my colleagues on the panel to discuss the details of these rules, but the progress we have made on both a significantly stronger capital regime and the expansion of the supervisory umbrella to cover designated nonbank financial companies are key developments in strengthening our financial system.

In February, I also highlighted the Council's work on money market mutual fund reform. At the end of 2012, the Council issued proposed recommendations on money fund reforms for public comment. Throughout this process, we have made it clear that the SEC is the primary regulator and should take the lead in driving reforms.

In June, the SEC proposed regulations to reduce the risks presented by money funds. Public comments will provide important feedback and information for the SEC to consider in developing a final rule.

Also in June, Treasury's Federal Insurance Office released its first Annual Report on the Insurance Industry and is working to complete its report on the Modernization and Improvement of Insurance Regulation in the United States.

I would also like to highlight for the Committee a few areas where Treasury intends to direct significant attention and resources during the remainder of the year to complete key outstanding pieces of reform. In his capacity as Chairperson of the Council, Secretary Lew is responsible for coordinating the regulations issued by the rule-making agencies responsible for implementing the Volcker Rule and the Risk Retention Rule. Finalizing these regulations will continue to be a top priority for the Secretary and the Treasury Department.

Treasury will also continue to engage closely with our regulatory counterparts at home and abroad to strengthen our ability to wind down failing financial companies while minimizing the negative impact on the rest of the financial system and the economy.

By the end of this year, we expect to approach the point of substantial completion of implementation of the Dodd-Frank Act, but that does not mean that we will be able to relax our guard. Constant evolution in the financial system and the activities of financial institutions will require regulators to be flexible and to stand ready to address new threats to the financial system.

Thank you, and I would be happy to answer any questions.

Chairman JOHNSON. Thank you.

Governor Tarullo, please proceed.

STATEMENT OF DANIEL K. TARULLO, GOVERNOR, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. TARULLO. Thank you, Mr. Chairman, Senator Crapo, and the rest of the Members of the Committee.

At this Committee's oversight hearing in February, I expressed the hope that 2013 would be the beginning of the end of the major portion of rulemakings implementing Dodd-Frank and strengthening capital rules. Progress over the intervening 5 months is bearing out this hope. The Basel III capital package is now final, as the Chairman has noted. I will say more on that in a moment. The Sec-

tion 716 rule is done. We have made good progress on the Volcker Rule and are on track to be done by the end of the year.

Late this year, we will publish a proposed rule for capital surcharges on firms of global systemic importance. The proposed rule on the liquidity coverage ratio, which is one of the special prudential standards for larger banks, will be out in the fall. And with one exception, we should have final versions of the other special prudential rules for firms with over \$50 billion in assets done this year. The one exception is the rule on counterparty credit risk on which, as I mentioned in February, we thought we needed to do a quantitative impact study.

On capital, the finalization of the Basel III package marks the end of major modifications to the capital rules applicable to the vast majority of the Nation's banks. The final capital rule substantially simplified some of the elements of the proposed rule that had been of greatest concern to smaller banks.

For the eight largest banking organizations already identified as of global systemic importance, we still have some work to do in building out a capital regime of complementary requirements that focus on different vulnerabilities and together compensate for the inevitable shortcomings of any single capital measure.

The first element of this regime, the Basel III risk-weighted capital ratio, is now complete.

Second, as I already mentioned, since the Basel Committee has just completed its methodological refinements for the capital surcharge on the largest, most systemically important firms, we will be getting out a proposed rule on this subject later in the year.

The third element, our stress testing and capital review requirements, is in place. These requirements provide a forward-looking projection of capital needs under adverse and severely adverse scenarios, taking account of losses that would be associated with each firm's specific portfolios.

Fourth, the three banking agencies have just proposed a rule establishing a higher leverage ratio threshold that will be an effective counterpart to the combination of risk-weighted requirements.

Fifth, we will be issuing an Advance Notice of Proposed Rule-making on possible approaches to addressing directly the risks related to short-term wholesale funding, including a requirement that large firms substantially dependent on such funding hold additional capital.

Sixth, in the next few months, we will issue a proposed rule on the combined amount of equity and long-term debt these firms should have in order to facilitate orderly resolution in appropriate circumstances. This is really a gone concern, as opposed to a going concern capital measure, but it is an important piece of an overall effort to confine the systemic risks posed by large banking organizations.

As to the form of systemic risk most in need of further attention and regulatory action, I will repeat what I said in February. It lies in the very large amounts of short-term funding other than insured deposits used by financial intermediaries. The various forms of this funding, though varying in the degree of vulnerability they pose, are all to a greater or lesser extent susceptible to destabilizing runs of the sort that set off the worst phase of the financial crisis.

The Advance Notice of Proposed Rulemaking to which I referred a few moments ago will address the particular vulnerability that exists when large amounts of this funding are concentrated in individual firms. But I should also emphasize that a financial system heavily reliant on such funding could create a good bit of systemic risk even if no individual firms were thought too big to fail. As the rules applicable to prudentially regulated banking organizations take effect, the chances increase that more such activity will migrate outside the prudential regulatory perimeter.

Measures on money market mutual funds and the tri-party repo market would represent a good beginning to address this vulnerability, but I believe we need to consider carefully possible additional steps in areas such as securities financing transactions to address the potential for runs in short-term funding regardless of whether the borrower is a large regulated institution.

Thank you very much for your attention.

Chairman JOHNSON. Thank you.

Chairman Gruenberg, please proceed.

**STATEMENT OF MARTIN J. GRUENBERG, CHAIRMAN,
FEDERAL DEPOSIT INSURANCE CORPORATION**

Mr. GRUENBERG. Thank you, Chairman Johnson, Ranking Member Crapo, and Members of the Committee, for the opportunity to testify today on the FDIC's actions to implement the Dodd-Frank Act, particularly in regard to mitigating systemic risk.

I will focus my comments on the recent capital rulemakings by the banking agencies and also on the FDIC's implementation of the systemic resolution provisions of Dodd-Frank.

Earlier this week, as Governor Tarullo mentioned, the FDIC Board acted on two important regulatory capital rulemakings. First, the FDIC issued an interim final rule that significantly revises and strengthens risk-based capital regulations through implementation of Basel III. The rule would strengthen the quality and quantity of risk-based capital for all banks, including by placing greater emphasis on Tier 1 common equity capital, which is widely recognized as the most loss absorbing form of capital.

The rule also makes significant changes to address a number of community bank concerns raised during the comment period on the proposed rule that I describe in some detail in my written testimony.

Second, the FDIC joined with the Federal Reserve and the OCC in issuing a Notice of Proposed Rulemaking which would strengthen the supplementary leverage ratio requirements for the eight largest, most systemically significant U.S. bank holding companies and their insured banks. The NPR would require these insured banks to satisfy a 6-percent supplementary leverage ratio requirement to be considered well capitalized for prompt corrective action purposes. Bank holding companies covered by the NPR would need to maintain supplementary leverage ratios of a 3-percent minimum plus a 2-percent buffer for a total 5-percent requirement.

Maintenance of a strong base of capital at the largest, most systemically important institutions is particularly important because capital shortfalls at these institutions can contribute to systemic distress and can have material adverse economic effects. Analysis

by the banking agencies suggests that a 3-percent minimum supplementary leverage ratio, which is required under Basel III, would not have appreciably mitigated the growth in leverage among these organizations in the years preceding the recent crisis.

In addition to these capital proposals, the FDIC has made significant progress in developing a more effective resolution framework for large, systemically important financial institutions, or SIFIs, as required by the Dodd-Frank Act.

Title I of the Act requires that certain large financial institutions prepare resolution plans, or living wills, to demonstrate how the company could be resolved in a rapid and orderly manner under the Bankruptcy Code.

Eleven large, complex financial companies submitted initial resolution plans in 2012, with the remaining covered companies required to file plans in 2013. Following the review of the initial eleven resolution plans, the agencies have developed guidance for these firms to detail what information should be included in their 2013 revised resolution plan submissions. These revised resolution plans will be subject to reviews for resolvability under the Bankruptcy Code. The FDIC and the Federal Reserve will be evaluating how each plan addresses a set of benchmarks outlined in the guidance which pose the key impediments to an orderly resolution.

While bankruptcy is the preferred option for resolution under Dodd-Frank, if resolution under the Bankruptcy Code would result in serious adverse effects on financial stability in the United States, Title II of Dodd-Frank sets out the orderly liquidation authority to serve as a last resort alternative.

To implement the orderly liquidation authority, the FDIC has developed a strategic approach to resolving a SIFI, which is referred to as a Single Point of Entry. In the Single Point of Entry resolution, the FDIC would be appointed as receiver of the top tier parent holding company of the financial group following the company's failure. Shareholders would be wiped out. Unsecured debt holders would have their claims written down to reflect any losses the shareholders cannot cover. And culpable senior management would be replaced. As I detail in my testimony, we believe the Single Point of Entry strategy holds the best promise of achieving Title II's goals of holding shareholders, creditors, and management of the failed firm accountable for the company's losses and maintaining financial stability at no cost to taxpayers.

Mr. Chairman, that concludes my remarks. I would be glad to respond to your questions.

Chairman JOHNSON. Thank you.

Comptroller Curry, please proceed.

STATEMENT OF THOMAS J. CURRY, COMPTROLLER OF THE CURRENCY, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. CURRY. Chairman Johnson, Ranking Member Crapo, and Members of the Committee, thank you for the opportunity to discuss those provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act that reduce systemic risk and improve financial stability.

The global financial crisis was unprecedented in its severity and exposed a number of fundamental weaknesses in the regulation and structure of the financial system. The Dodd-Frank Act sets new requirements for capital, liquidity, and higher-risk activities and provides additional regulatory tools that will mitigate future problems.

In my written testimony, I provided a detailed update on what the OCC has done to implement those provisions along with other steps we have taken to ensure that national banks and Federal thrifts operate safely, even in times of economic stress. This morning, I would like to focus on a handful of key areas.

First, I am pleased to tell you that the OCC has completed work on all of the rulemakings required under Dodd-Frank that we have authority to implement on our own. This includes rules related to lending limits, stress testing, credit ratings, and retail foreign exchange transactions. We are continuing to work on an interagency basis on other Dodd-Frank provisions, including the Volcker Rule.

Most recently, we joined with the other bank regulatory agencies in a comprehensive overhaul of the capital rules that apply to banks and thrifts. On Tuesday, like my colleagues, I signed the new domestic capital rule, which takes important steps to improve the quantity and quality of capital for all banks and thrifts while setting higher standards for large institutions. This rulemaking includes requirements laid out in Dodd-Frank.

I also issued a proposed rule with the other agencies that would double the leverage ratio to 6 percent for the largest and most interconnected U.S. banks. The new domestic capital rule raises capital ratios, expands the base of assets for risk-based capital calculations, and emphasizes common equity, which has proven to be the form of capital best able to absorb losses.

The rule also mandates that all institutions maintain a buffer of additional common equity and restricts payment of dividends and bonuses if that buffer falls below 2.5 percent. In addition, for large banks and thrifts, we established a countercyclical buffer that could be activated during upswings in the credit cycle to protect against excessive lending and will consider in a separate rulemaking a surcharge that would apply to the largest, most systemically important institutions. With these additional requirements, the largest U.S. banks could be required to hold Tier 1 common equity equal to as much as 12 percent of their risk-adjusted assets during upswings in the credit cycle.

Throughout this process, one of my top goals has been to minimize the impact of these rules on community institutions. We found that the vast majority of community banks already have enough capital to meet the new requirements. We conducted extensive outreach and paid close attention to comments we received from community banks and thrifts. As a result, we made a number of revisions to the proposed rule, particularly in the areas of residential mortgage exposures, AOCI, and trust preferred securities that, I believe, will effectively address their most important concerns.

While the financial crisis revealed the need for additional regulations, it also highlighted the importance of strong supervision and close collaboration among the bank supervisory agencies. At the

OCC, we have raised the bar on our expectations for the institutions in our large bank program, requiring higher standards for audit, governance, and risk management. We have focused particular attention on independent directors. We expect them to set strategic direction for the bank and to have the knowledge and the will to provide a credible challenge to management.

In addition, we are working with the large banks we oversee to reduce the number and complexity of the legal entities within their organizations and to ensure that those entities align properly with business lines at each bank. This process will take time, but it will ultimately improve transparency, risk management, and governance, and will make it easier to deal with the resolution of large institutions that do get into trouble.

Finally, I am pleased to say that the national banks and Federal thrifts supervised by the OCC have made significant progress in raising capital and have been reducing their reliance on volatile funding sources. At the same time, asset quality has improved across the board. The national banking system is substantially stronger today than it was before the crisis.

We believe these are important achievements, but we also recognize that much remains to be done. As we continue the important work of implementing the Dodd-Frank Act, I can assure you that the OCC will work closely with the other regulatory agencies to ensure that the banks and thrifts we supervise are safe and resilient enough to stand up to future economic disruptions.

Thank you very much, and I would be happy to answer any questions.

Chairman JOHNSON. Thank you. Thank you all for your testimony.

We will now ask questions of our witnesses. Will the Clerk please put 5 minutes on the clock for each Member.

Ms. Miller, what steps are being taken to finalize rules that will do the most to mitigate systemic risk? What is the time table to complete key rules, and as the Chair of FSOC, what is the Treasury doing to better coordinate these efforts with regulators here and abroad?

Ms. MILLER. Thank you very much for your questions. First of all, I think you have heard this morning about some of the most recent progress to finalize rules that will put into effect the objectives of Dodd-Frank and the broader capital regimes internationally. When I was looking at the testimony that my colleagues prepared today, I thought it was very useful to look at the helpful lists they provide of finalized rules, of rules that are in progress, and what is left to be done, and I agree very much with the sentiment that we are closer to the end than the beginning here.

I think that the work that has been done to strengthen financial institutions, to put in place the important architecture of Title VII on the derivatives treatment in markets, I think the Title II work and Title I work to help with winding down systemically large institutions, is enormously useful. I think one of the most damaging aspects of the financial crisis was not having in place clear rules of the road of the way these things should work when you get into difficulty.

So I applaud the regulators for the work that has been done. I do think that we have some quite important roles to finish, and I think that it is possible that we will see significant progress this year.

Chairman JOHNSON. Governor Tarullo and Comptroller Curry, I appreciate the steps taken in the final Basel III rule regarding insurance companies. What next steps will the Fed take to create capital rules that are better suited for companies that focus on the business of insurance?

Mr. TARULLO. Well, Mr. Chairman, you referred to the provision that we included in the final rule that actually defers our capital rules for firms with more than 25 percent of their activities in insurance underwriting. The reason we did that was that, as you and Senator Crapo know and have pointed out, there are a number of products that insurance underwriters develop and then market to the public which are unlike bank products.

The prototypical example of that would be the so-called separate accounts. Separate accounts come in a lot of different varieties. They are not susceptible to a single capital treatment, and they are certainly not susceptible to the kind of risk weighting we would do for a bank asset.

As the three of us were trying to complete the Basel III package, it did not seem as though it was sensible to try to rush answers to some of those novel questions, but it also did not seem sensible to hold up the Basel package. So we have delayed the final rules on insurance-related holding companies in order to give ourselves the opportunity to look more deeply into some of those products.

Now, having said that, I think it is important to note that we do operate under a constraint here. That is to say, the Collins Amendment does require that generally applicable capital requirements be applied to all the holding companies that we supervise. And while we can and will take into account the unique characteristics of insurance products that are not, by law, marketed by banks and other banking organizations, we do not have the ability to risk weight, for example, the same security that is held by a bank or by an insurance company differently, and at some level, it does not really make any sense to do it differently. The asset has the risk that it has.

The problem here, Mr. Chairman, comes on the liability side of the balance sheet. Bank-centered capital requirements are developed with an eye to the business model of banks and the challenge that the FDIC would have in resolving a bank, or now a systemically important banking organization, that would be in deep trouble. The more or less rapid liquidation of a lot of those claims and the runs on a lot of the funding of that institution lie behind the setting of the capital ratio.

But the liability side of an insurance company's balance sheet—a true insurance company, somebody selling life insurance, for example—is very different. There is not a way to accelerate the runs of that funding. People are going to continue to pay their premiums and, presumably, they are not going to die any more quickly just because the insurance company is in some sort of difficulty. But we are not in a position to take account of that different business

model in setting requirements, which under Collins have to be the generally applicable capital requirements.

So with that constraint, I can assure you that we are working as much as we can on tailoring risk weighting for unique insurance products, but we are a little bit confined here.

Chairman JOHNSON. Mr. Curry and Mr. Gruenberg, how will each of your agencies monitor and evaluate the impact of the new Basel III requirements on community banks to minimize unnecessary burden? Mr. Curry.

Mr. CURRY. Thank you, Chairman. We would primarily rely on our supervisory process. We are required by statute and by sound supervisory policy to examine each of our national banks and Federal thrifts on an annual or a little bit less frequent basis for well-capitalized institutions and well-managed institutions. That would be our primary method of evaluating the impact.

We are very sensitive to the impact of the capital rules on those institutions that we supervise, and that has been part of our rationale during the rule-making process itself, to make both our Notices of Proposed Rulemaking and our final actions as clear as possible to those institutions through Web casts, through the publications that we jointly issued, and with the pamphlets that my office has issued. But we plan on working with the institutions, and there is an extra year before the rules trigger for community banks and thrifts.

Chairman JOHNSON. Mr. Gruenberg.

Mr. GRUENBERG. The impact of Basel III on community banks has been a matter of particular attention for us at the FDIC. As you know, we are the lead Federal supervisor for the majority of community banks in the United States, so it has been a particular focus, which is reflected in the close attention we paid to the comments that we received on the rulemaking itself and the changes, as you pointed out, that were made in the final rule in response to those comments.

But, in addition, we really want to work hard as the rules come out and the banks have to prepare for implementation to be sure they really understand well what is contained in the final rule. We have organized a series of outreach efforts focused on community banks to explain and make as clear and straightforward as possible what the requirements are.

We are going to be holding outreach sessions in each of our six regional offices around the country where we are going to invite community bankers from the region to either attend or call in. We also are creating a video of the presentation that will be posted on our Web site that any community bank can look at if they are not able to attend the session. We are creating two guides, a shorter one and a longer one, that can be utilized by community banks to facilitate their compliance with the rulemakings, in effect, a short-hand guide to compliance with the rules.

And we are also designating experts in each of our regional offices. So any community bank that may have a question as they go through the rules and are uncertain as to how the rules would apply to their specific institution can call and get an individual to walk them through it. This will also be a matter of close attention by our examiners as they examine each of the institutions, as well.

As Comptroller Curry pointed out, for community banks, there will be some lead time here in terms of the beginning of implementation. It will be January of 2015, and we really want to use that period to help the institutions prepare for implementation and put them in a position so they can do so in a reasonable and cost-effective way.

Chairman JOHNSON. Senator Crapo.

Senator CRAPO. Thank you, Mr. Chairman.

My first question is for the Federal Reserve, the FDIC, and the OCC. On July 2, the Federal Reserve finalized Basel III capital rules and previewed plans for even tougher capital rules for big banks. The final Basel III rule issued by the Fed addressed only a subset of the issues jointly proposed by the Fed, the FDIC, and the OCC. And on July 9, the FDIC announced that it will consider Basel III as an interim final rule and proposed a supplementary leverage ratio of 5 percent for large bank holding companies and 6 percent for the banks that are owned by these holding companies. A number of issues remain outstanding, including particularly capital rules for insurers and large banks.

My question is, can you provide an insight for us into what we can expect from the regulators on these issues and when?

Mr. TARULLO. On the proposed rule on the leverage ratio, we put it out for comment, as you have to do with all proposed rules. We have got a number of questions in there and we will receive comments on it. But in the normal course, you get the comments, you see whether there are things you want to change, and then you put the rule into final. So, until we see the comments, obviously, we cannot give a timeframe, but I think everybody's intention was to get the rule out, get the comments, and then try to move as expeditiously as possible with finalizing that rule.

With respect to some of the other things, Senator, that the Fed specifically mentioned that are not OCC and FDIC initiatives, the additional capital for—excuse me, gone concern capital, the long-term debt requirement, is something which we have been working on for quite some time in close consultation with the FDIC, and I anticipate we are going to get that proposed rule out in the fall. There are still some technical issues being worked through, but I think we have got a sense of how we want to go about making sure that the resolution of a large systemically important firm could proceed smoothly.

The area where we have not moved as far down the road is in that wholesale funding area, which you mentioned in your introductory statement, as did I. As I say, I think the major vulnerability that remains is that associated with large amounts of runnable short-term funding. And what we want to do is, in an Advance Notice of Proposed Rulemaking, get out some ideas as to how we might address that, certainly with respect to the very large institutions, and that is where the relationship between capital and liquidity requirements comes in—

Senator CRAPO. And do you know when we could expect that?

Mr. TARULLO. We will get the ANPR out in the early fall, I think. But just to be clear, an ANPR is basically—is not like a rule text. The ANPR says, here is the way we are thinking and tries to elicit

at a relatively early stage of regulatory development people's reactions to those approaches.

Senator CRAPO. Thank you.

Mr. Gruenberg.

Mr. GRUENBERG. For the FDIC, in the capital area, the big outstanding work will be completing the rulemaking in regard to the leverage ratio. We really viewed it as an important complement to the Basel III rulemaking. Basel III would strengthen the quality and quantity of risk-based capital. Frankly, the Basel III rule in regard to the leverage ratio did not have a comparable strengthening. In effect, the proposed leverage ratio rule is to create a balance, to strengthen the leverage ratio in a way that is comparable to the strengthening of risk-based capital.

We think that combination actually makes for the most balanced and strongest foundation of capital, particularly for our largest and most systemically important financial institutions. We really view that as an important part of moving to completion on the entire Basel III package, and as Governor Tarullo indicated, we would hope to reach conclusion on that, I would think, by the end of the year.

Senator CRAPO. Thank you.

Mr. Curry.

Mr. CURRY. Like the FDIC, our primary focus at the OCC is on reviewing the comments that we expect to receive on the supplemental leverage ratio. We issued the NPR with several questions where we are trying to determine what the potential impact of that proposal would be, both pros and cons. And we, like the FDIC, view the supplemental leverage ratio as basically belts and suspenders to make sure we have a properly calibrated leverage ratio that works well with the existing risk-based capital regime that we have in place.

Senator CRAPO. Thank you.

Chairman JOHNSON. Senator Brown.

Senator BROWN. Thank you, Mr. Chairman.

Governor Tarullo, thank you for your comments in answer to Chairman Johnson's question on insurance and the Collins Amendment and the work you are doing there.

This is my question for Governor Tarullo, first. We clearly agree we need stronger, better capital standards. We would both like them to be higher than they are. I am particularly concerned, though, that banks can use risk weights and internal models to game their capital rules. *The Financial Times* reported today that the biggest banks plan to use what they said optimization strategies, not more equity, to meet the new leverage ratios. An executive at a large U.S. bank on Wednesday said, quote, "We are going to be able to pull a lot of levers." Analysts at Goldman Sachs noted in research for clients that, quote, "Banks have a lot of options to mitigate the impact."

What more should we be doing—should you be doing—in terms of using Basel III, using the Collins Amendment, using the proposed new leverage ratios in Section 165 of Dodd-Frank to address this potential gaming of the capital rules that appear to be imminent?

Mr. TARULLO. Well, Senator Brown, let me begin by echoing a term that Chairman Gruenberg used, which—I am not sure he used the term, but he had the concept of complementarity of the relationship between different capital measures.

You know, if we think back to how we started getting risk-weighted capital in the first place, it was actually in the early 1980s. Up to that point, the regulators basically used some variant on a leverage ratio. And then what we saw with savings and loans and famously with Continental Illinois was that the banks were gaming the leverage ratio by taking the most risk they could for a given amount of leverage. And it was at that moment when the regulators began to say they needed something else which looked at the actual amount of risk that the bank was taking. So thus was born the concept of risk weighting, which saw its way into the Basel I agreement.

Now, what we saw more recently, and Basel II was kind of the height of this, was the opportunity for gaming or arbitraging once you have your risk-weighted capital requirements in place. The model-driven approach—the internal model-driven approach to risk weighting—has the potential for problems both because the models are backward looking and thus they may be honestly put together, but they do not contemplate new problems in the world which can create different loss functions. They also have the potential, obviously, to be gamed, because they are sometimes extremely opaque and difficult to monitor effectively.

Now, it is important to note, Basel II has never governed the capital ratios of any U.S. bank. We are still basically on a variant on Basel I, and with the Collins Amendment, we will always have the standardized risk-weighted capital as our base. But, as I saw in research before coming to the Fed, in some other countries the introduction of the internal models-driven approach pushed capital down pretty quickly.

So, in terms of what we have got to do, we have got to take account of the shortcomings of each of these, the potential for gaming, whether it is gaming of risk-based capital or, as you just noted in the FT story, the potential for gaming leverage ratio, and to make sure that we have got a good risk-weighted approach, which I think we have now got in the Basel III package; a leverage ratio which is a strong complement and floor to that, making sure that you cannot game risk weighting to get too much leverage; and third, and from my point of view, this has been the real innovation in banking regulation in the last 4 or 5 years, is the stress testing that we are now doing for firms over \$50 billion, because what we do with stress testing is we basically say we are going to get portfolio specific and risk specific, but we are going to do it. We are not going to rely on the internal models of the banks to do it. We are going to have a set of loss functions that the Fed creates and we are going to run their portfolios through that set.

I think those three things together provide a quite solid base, each of which compensates for the potential shortcomings of the other.

What more do we have to do? I will come back to what I said earlier. I think what more we have to do is pay more attention to, again, the liability side of the balance sheet, the short-term whole-

sale funding which can run. And what I am interested in is pursuing the relationship between capital and the liability side of the balance sheet, which has generally not been done. Usually it is capital and the asset side of the balance sheet. I think we need to complement that.

So whether we do it through increased capital requirements based on the amounts of wholesale funding or, as some of my colleagues have suggested, through an increase in the systemic risk surcharge, one way or another, I think we have got to take account of business models and funding models which create more risk in each of the firms and the system. So I guess I would add that as a fourth piece——

Senator BROWN. Thank you.

Let me ask my other question of Ms. Miller. You gave a speech in April, Ms. Miller, in which you said, and I will quote, “The evidence is mixed whether market participants, specifically lenders to bank holding companies, nonetheless provide any funding advantage to the biggest financial companies based on some belief that the Government would bail them out if necessary.” There was a lot of coverage on that speech and that statement.

I am going to read you something else and then ask you a question. Quote, “A perception continues to persist in the markets that some companies remain too big to fail, posing an ongoing threat to the financial system. It produces competitive distortions because companies perceived as too big to fail can often fund themselves at a lower cost than other companies. This distortion is unfair to smaller companies, damaging to fair competition, and tends to artificially encourage further consolidation and concentration in the financial system.”

The second statement was made on Tuesday by the three other panelists. Why are they wrong and you are right?

Ms. MILLER. Thank you for the good question. I am not certain that it is a question of wrong and right. I think we are in an evolving period of time where perceptions are changing and where the law has put in place a regime where we can actually work to eliminate any perception or expectation of taxpayers bailing out large financial institutions.

To come back to my statements, I think that with the passage of time, with the passage of the Dodd-Frank Act, with the implementation of a number of these rules, the data in the marketplace is quite mixed now looking at the funding costs for large institutions and small institutions and any relative advantage. And my ask was simply that we do some more work on this question, particularly asking some of the academics who have looked at this, because their work is rather dated and predates the passage of Dodd-Frank, that it would be a good time to step back and look at that again to measure the impact of the steps that have been taken.

Senator BROWN. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Vitter.

Senator VITTER. Thank you very much, Mr. Chairman. Thanks to all the panelists for being here and for all your work.

First, I just want to briefly and publicly again applaud the FDIC decision on capital. I think it is an important first step in the right direction. If I could ask all of the panelists, and I am sorry if you

are repeating yourselves, it seems to me this sort of requirement is important and, hopefully, effective, because it is systemic. It does not just depend on sort of regulations and regulators, but it goes to the heart of the stability of an institution without folks having to catch things in real time that may be spiraling in a negative direction. Do all of you fundamentally agree with the premise of higher capital ratios as enunciated by the FDIC proposed rule?

Mr. CURRY. The OCC is a member of the FDIC Board, so in that respect, I voted for the FDIC proposal. But, also, this is an inter-agency effort by the OCC and the Fed, and at the same time that I voted at the FDIC, we issued our own as a joint rule and Notice of Proposed Rulemaking on the same supplemental leverage ratio.

Mr. TARULLO. And, Senator, the Fed simultaneous with the FDIC Board meeting voted on the proposed rule, as well.

Senator VITTER. Right.

Mr. GRUENBERG. Senator, I would underscore this really was a joint, collaborative effort among the three agencies, and I think there is really common agreement on this point.

In regard to the strengthening of the leverage ratio, the importance of strengthening the cushion of capital, particularly for the large systemically important institutions that really pose a risk to the financial system and significant disruption to the economy if they get into difficulty, the value of having a stronger cushion of capital to enable them to better withstand a stressful environment, reduce the likelihood of their failure and the potential impact on the Deposit Insurance Fund was a threshold concern for us. There was a general recognition that the 3-percent minimum leverage requirement that is in Basel III was an important step because it is the first time there was an international leverage ratio standard established for all the participants in the Basel accord.

So establishing the leverage ratio in the accord was meaningful and important. From our standpoint, the analysis suggests there really was not a strong enough standard, particularly for our largest most systemic institutions, which is why we came forward with the proposal to strengthen the supplementary leverage ratio requirement.

Senator VITTER. Great. Thank you. And I did not mean to suggest by the question that it was somehow FDIC only. I understand the nature of all the discussions and decisions and proposed rule.

So, all of you agree with the basic premise. Then the question, in essence, becomes what is the right level? What is the right number? What is the right percentage? And I continue to be concerned while this is a very important step, I think, in the right direction, that it is not a significant enough number.

It strikes me, in particular, that you look at smaller banks, community banks, without any regulatory requirement. They are way above this. And it seems to me that is interesting and instructive for two reasons. Number one, because the only thing getting them there are market demands and pressures about sustainability and viability. There is not a direct regulatory requirement that gets them that high. Number two, they are not systemically significant like the megabanks we are talking about are.

Does it not strike you in some sort of basic way that for the megabanks to be way lower than them is the reverse of, arguably, what it should be?

Mr. TARULLO. Senator, I think probably there is a variance in where banks are on leverage ratio as opposed to risk weighting. And, of course, this is what a number of us were saying earlier, the importance of the complementarity between risk weighting and leverage. Each compensates for the way in which the other regulation can be arbitrated.

I think what is most important, though, is the area of agreement which you have been identifying, which is there needs to be more capital in the largest systemically important institutions. From my vantage point, the vulnerability that I see is on the funding side, the short-term funding by the largest institutions. You know, one can differ on what you want as the road into the higher capital requirements. I think I would rather respond most directly to the vulnerabilities that I see.

But, again, certainly on this side of the table and from what I have heard on your side of the dais, as well, there is a general agreement that we do need to continue the process of pushing up capital levels. They have already been doubled in our largest institutions in just the last few years. Less risk and a doubling of capital. And we need to continue that work over the next several years, as well.

Senator VITTER. Any other response to my observation? I realize there is a variance in everything, but, in general, it is certainly true that community banks are still way above what we are talking about.

Mr. GRUENBERG. Senator, you raise an important point. As a general matter, the largest institutions have managed themselves to a lower leverage ratio than the smaller institutions. That was part of the impetus, frankly, for our proposal. It is a judgment call on how high and how fast to push it up.

The level we proposed is a substantial increase by our estimates. If it had been in effect in the third quarter of last year for these largest institutions, it would have required nearly an additional \$90 billion of capital at the bank level and over \$60 billion of additional capital at the holding company level. We think it creates rough comparability with the strengthening on the risk-based side in Basel III.

In the NPR, we ask the question for public comment, is this the right level? Should it be higher? Should it be lower? Certainly, in the comment period, we will take into account the input that we receive.

Senator VITTER. Right. Mr. Chairman, if I could wrap up in 30 seconds, I take all of your comments as encouraging in suggesting that this is an ongoing process. This is not the final word, necessarily, or the end of the road, and I certainly want to encourage that.

And let me quote *The Financial Times* from last night as further encouragement of that. They say, quote, "U.S. banks believe they will be able to meet the new regulatory requirement on debt levels by shuffling assets between their subsidiaries and using other optimization strategies to reduce the amount of leverage they report,"

and that, “no banks are expected to raise equity to fill an apparent capital shortfall of more than \$60 billion across the industry.”

So I am out of time, but I just make that observation. Now, I realize that shifting of assets is not necessarily insignificant or trivial, but it is a significant observation, I think, that they are not raising any capital and I cite that as further encouragement to continue down this path.

Chairman JOHNSON. Senator Warren.

Senator WARREN. Thank you, Mr. Chairman, and Mr. Chairman, as we all know, Wall Street’s high-risk betting nearly destroyed the economy. But since then, we have made real progress with Dodd-Frank’s implementation.

But despite this progress, the four largest banks are now 30 percent larger than they were just 5 years ago and they have continued to engage in dangerous high-risk practices. So later today, Mr. Chairman, Senators McCain, Cantwell, King, and I will introduce a 21st Century Glass-Steagall Act. For half a century after the Great Depression, Glass-Steagall kept this country safe by separating the risky activities of investment banks from the basic checking and service and savings accounts that consumers rely on every day. The banks lobbied for weaker regulations and eventually the regulators started unraveling Glass-Steagall, and finally in 1999, Congress repealed what was left of it. So now we propose a 21st Century Glass-Steagall so that we can return to the basics and try to keep the gamblers out of our banks.

Now, based on what the regulators did to Glass-Steagall over the past 30 years, I do not expect anyone on this panel will jump up and endorse the new Glass-Steagall bill. Even so, we are going to keep pushing for it.

But I want to spend my time today focusing on another part of this issue and that is that a few weeks ago, SEC Chair Mary Jo White announced that she is going to require admission of guilt in a wider variety of enforcement actions. Now, you remember that under its old policy, the SEC required an admission of guilt only very rarely, pretty much only when the defendant had already admitted guilt in some other context or had admitted it criminally. Now, the SEC has said it will be tougher when large numbers of investors have been harmed intentionally or when the defendant unlawfully obstructs the Commission’s investigative process.

Now, I think the same principles that apply to the SEC enforcement would also apply to other regulators. So my question is whether or not you have considered moving in the same direction as Chair White on admission of guilt policies. Governor Tarullo, what about the Fed?

Mr. TARULLO. Well, Senator Warren, after the February hearing where you raised a similar question, I went back and asked people at the Fed, the people who do the compliance and enforcement generally, to think this through, and we have had conversations subsequent to that. I guess our, at least provisional, conclusions are the following.

First, it is important to note that with respect to the Justice Department and the SEC, for example, essentially—not exclusively in the case of the SEC—but they are essentially enforcement agencies. That is, they take rules which have been broken and they

bring enforcement actions. They do not have extensive on-site supervisory presences, one.

Two, the precedent value of an admission at the SEC, for example, is of substantial consequence, potentially, for shareholders derivatives suits and other litigation that may be working off the same set of facts. For us, with prudential regulation, we are basically trying to protect the taxpayers. What we are most interested in is making sure that any violations of or unsafe and unsound practices are remedied as quickly as possible.

Senator WARREN. Well——

Mr. TARULLO. We are not creating taxpayer derivative——

Senator WARREN. But let me just ask you the question on that, though, Governor Tarullo. I would have thought you would have described your job as trying to prevent them from breaking the law at all——

Mr. TARULLO. Well, sure.

Senator WARREN. ——and that when you catch them breaking the law, you want them to stop breaking the law, but you also want to impose an appropriate penalty.

Mr. TARULLO. No, and that, we do. We do impose penalties. We do impose penalties.

Senator WARREN. And that means that you often settle with them rather than taking them to trial.

Mr. TARULLO. Well, sure, but——

Senator WARREN. And how much you can settle with them for, that is, how much they will really pay as a result of having broken the law, depends, in part, on how they evaluate your willingness to push them to trial. So the question I am asking about is really how much leverage you have, and what SEC Chairman White has said is that she is going to step it up. She is going to be tougher and she thinks that is going to give her better leverage, or at least I think that is the assumption she makes here. And what I am asking is whether or not the Fed plans to do the same.

You know, when I was here back in February and I asked the question about when is the last time you took a large financial institution to trial, the answer was not good and it confirmed the worst fears of the American public, that the Government is quite willing to take ordinary individuals to trial, but when it comes to big banks, they are not so enthusiastic about enforcing the law against them. And so that is the question I am trying to ask about.

I understand it is different when you have supervisory responsibilities, but you have a responsibility to see to it that this law is going to be enforced——

Mr. TARULLO. No, no——

Senator WARREN. ——and part of that is taking people to trial. That is one of the tools in the toolbox.

Mr. TARULLO. Well, it is a tool, but actually, we have, I think, in some ways, a more immediate and effective tool, which is the exercise of supervisory requirements and getting people to change what they have done. Now, the question of——

Senator WARREN. Forgive me, Governor Tarullo. I appreciate that you have another tool that you sometimes use quietly and out of public sight. The question I am asking about, though, is whether or not you are going to require something more public following

SEC Chair White's change in policy so that she is going to require admissions of guilt, which at least get us to a place where we are doing something out in public and perhaps leading toward trials on a more regular basis.

Mr. TARULLO. The third point I was going to make, actually, was the third conclusion of our discussions internally was that there may be instances in which doing so would be warranted for a variety of reasons. The first two points I was making were simply that given the tools and the abilities we have and the effort to maximize the benefits to the public of the resources that we do have, generally speaking, the use of the supervisory mechanisms, is probably most effective.

Now, that does not go to the question of what the fines should be, and I think that is a legitimate question, whether you are doing it through a supervisory process or whether you are doing it through a quasi-judicial or a judicial one.

Senator WARREN. So, does this mean you will be considering re-evaluating the policies along the same lines that the SEC has?

Mr. TARULLO. Well, no, we are in a fundamentally different situation than the SEC. I think we are in a different situation. Now, I think, you know, if you have seen with the more recent fines that have been substantially larger than historic precedent, I think you do see some effort to ramp up the kind of enforcement mechanisms being used, but I—

Senator WARREN. I will say on that, Governor Tarullo, since I see that we are over time, and I will be careful here, Mr. Chairman, I will say there has been some real question about the settlements that you have made. We talked about the mortgage foreclosure settlement, also, at an earlier hearing, and that Congressman Cummings and I have asked for documentation about what the banks did wrong and more details about how it was determined who was going to get what kind of compensation from that. That was 6 months ago. We still have not had it.

I just want to make the point that if you had real confidence in your settlements and that if people could see the details of those settlements, what the banks did wrong and how we determined—how you determined how much money would go to individual people, then the public could evaluate for itself whether or not you are really out there fighting on their behalf, and so far, you have not been willing to do that.

Mr. TARULLO. I think that set of issues is a different set of issues, because if one is talking about the transparency of enforcement actions no matter what their origins—law enforcement, regulatory, administrative, supervisory—I actually do think that the bank regulators need to think more about when we put out the public notice of the kinds of supervisory actions that have been taken.

And I think just as, in a somewhat different context, we have moved a long way with stress tests and the publication of results on the stress tests, I think there is a pretty good case to be made for thinking about putting enforcement actions, orders that we will use, as you say, internally, out on the public record, as well—

Senator WARREN. Well—

Mr. TARULLO. —which I think does serve some of those purposes, but in our context.

Senator WARREN. I detect in that some change and I appreciate it and I say, Mr. Curry, I will get you next time.

[Laughter.]

Senator WARREN. OK. Thank you. Sorry, Mr. Chairman.

Chairman JOHNSON. Senator Heitkamp.

Senator HEITKAMP. Thank you, Mr. Chairman.

Just not to belabor Senator Warren's point, but the best enforcement tool is a good deterrence. And we know from a lot of experience and the work that we have done in the past, whether it is in prosecution, white collar crime is deterred by a little sunshine and an occasional piece of litigation that can, in fact, expose bad behavior. So, I just want to add my two cents to that effort.

But I want to take this in a different direction, and this question is really for Mr. Tarullo and Mr. Curry. You know, there has been a lot of discussion recently on the standards of foreign banks compared to the standards for domestic banks. Can you speak to the importance of ensuring foreign banks meet the same capital requirements for their U.S. operations that U.S. banks do, and I would pass it to you, Mr. Tarullo.

Mr. TARULLO. Thank you, Senator. Well, as I know you are aware, we have a proposed regulation on foreign banking organizations which would require that the largest foreign banking organizations in the United States maintain Basel III minimum capital levels and also have liquidity requirements. The reasons for that are pretty straightforward.

One, the nature of foreign banking in the United States has changed substantially over the last 15 years. Five of the ten largest broker-dealers in this country are foreign bank owned.

Two, during the financial crisis, foreign banking organizations of all sorts drew at the discount window if they were commercial banks. They took advantage of the various liquidity facilities which the Fed put in place if they were not commercial banks. And thus, it became pretty apparent that, at some level, we, the regulators and the central bank, were having to play a role when they were in a less-than-strong capital liquidity position.

Three, I think it is notable that any large U.S. banking organization in the European Union already has to be separately incorporated and meet local capital and liquidity requirements. So in some sense, we are kind of catching up with what the European Union has already done.

So for all those reasons, Senator, I think it is very important that we get that FBO reg out. We are taking comment on it now. I know there has been some push-back from some institutions that do not want to hold capital in the United States, but I just think it is not a sustainable position for us or any country that hosts large foreign financial institutions not to make sure that those institutions are stable within its own country, because, ultimately, it affects our financial stability, as well.

Senator HEITKAMP. Mr. Curry.

Mr. CURRY. The OCC supervises Federal branches and Federal agencies. Under the current set-up, we would be looking to the parent for capital support, so we welcome the Fed's proposal, its FBO

proposal in terms of enhancing the availability of capital here domestically.

We also, as part of our supervisory process, our agreements and auditors with respect to those Federal branches and auditors would have capital equivalent provisions to make sure that U.S. customers and U.S. operations would not be adversely impacted in the event of an insolvency of the foreign parent.

Senator HEITKAMP. And I raise this issue because as we talk about systemic risk and as we talk about what, in fact, are our challenges looking forward, not paying attention to this issue could, in fact, damage and undo every good deed that you have been trying to accomplish in all of this regulation. So we are going to be watching this issue very closely, not only from the standpoint of making sure that there is not unfair competition, but also making sure that we are closing the loop on all of the institutions that, in fact, prevent systemic risk to our economy.

Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Tester.

Senator TESTER. Yes. Thank you, Mr. Chairman, and thank you all for being here today.

I have got a couple questions for Governor Tarullo and one for Mary Miller, so, Tom, you and Martin can breathe a sigh.

[Laughter.]

Senator TESTER. Governor Tarullo, first off, congratulations on your efforts in moving forward with the capital and liquidity and leverage standards. I want to visit with you this morning on a separate Dodd-Frank issue, which is the treatment of nonfinancial end users and whether they are subject to mandatory margins.

As you know, the Congressional intent in this area was explicit in that nonfinancial end users should be exempt from the mandatory margin. However, the legislative language in the statute is less clear than I would have hoped. The CFTC and the SEC have issued proposed rules that exempt nonfinancial end users from that mandatory margin and transactions in which they are counterparties, but the Fed has taken a slightly different approach.

At a hearing before this Committee nearly a year ago, Chairman Bernanke indicated that the Federal Reserve's reading of this statute is such that it requires you to impose mandatory margin on nonfinancial end users despite Congress's intent to the contrary. Chairman Bernanke indicated that the Fed would be very comfortable with efforts to make the exemption, which was clearly the intent of Congress, more explicit in the statute. So we have introduced legislation, Senator Johanns and I, cosponsored by a number of folks on this Committee, that would in a surgical fashion ensure that the statute is clear as to Congressional intent on this matter.

So, just to be clear, would eliminating this mandatory margin requirement have any impact on the Fed's ability to set appropriate capital or prudential standards regarding institutions' book of derivative trades?

Mr. TARULLO. Simply removing that provision would not, Senator, so long as it did not go further and affirmatively say that we could not put prudential requirements in in an appropriate circumstance.

Senator TESTER. Super. What other checks and balances exist to enable the Fed to address safety and soundness concerns that could arise from swap transactions involving nonfinancial end users?

Mr. TARULLO. Well, we have two, basically. We obviously have a general safety and soundness authority, and when we see things that are being done in an unsafe or unsound fashion, we can seek a change in that. That is actually the way we tried to navigate the Scylla and Charybdis of the legislative language and the legislative intent, is to set up something which tries to track good risk management. But you are right. Our reading of the statute said we could not simply exempt it.

But I do not think anybody, certainly at the Fed, has the belief that we needed anything additional in the legislation, and if the intent of Congress was not to affect the end users, the vast majority of whom are posing no systemic risk whatever, then we have no problem with that change.

Senator TESTER. OK. Now, setting aside the tools at the Fed's disposal, clarifying this exemption from mandatory margin for nonfinancial end users would not impact the ability of individual financial institutions to set margin standards based on their credit assessment of counterparties that are nonfinancial end users. Would you agree with that statement?

Mr. TARULLO. Senator, I think your intent, if I understand it correctly, is basically just to change current law so that there is no instruction from Congress to the regulators saying you have to put some sort of margin requirement—

Senator TESTER. Correct.

Mr. TARULLO. —in with end users.

Senator TESTER. With the nonfinancial end users.

Mr. TARULLO. Right. Exactly. Limited to that, it would not impinge on the ability of any entity to do its own risk management. It would not impinge on our ability to use our full panoply of supervisory tools.

Senator TESTER. OK. So the banks still have the ability to set margin requirements, but there would not be a requirement to impose mandatory margin requirements that would not normally be required to do. OK. Good.

Given all of the other mechanisms at the Fed's disposal in setting capital and prudential standards regarding these transactions in a more targeted fashion, is there any reason why the Fed would also need the statutory authority to impose mandatory margin on nonfinancial end users?

Mr. TARULLO. No, sir.

Senator TESTER. OK. Thank you very much. We need to get this done. I mean, I think we need to deal with this issue very, very soon, or we are going to see \$5 to \$6 billion sucked out of the economy as the nonfinancial end users raise money to set aside to meet what I think are unintended consequences, and I think this is inefficient and a shame, particularly since the intent of this drafting was to shield nonfinancial end users from the costs which would not reduce systemic risk. So we are going to keep working on that.

I have a question for you, Mary Miller. There are a group of us on this Committee that are working on GSE reform to move the housing system forward while preserving the 30-year note. What is

your opinion on dealing with Fannie Mae and Freddie Mac? Would you agree that this is an important task to take on, to make sure that not only Fannie Mae and Freddie Mac are secure, but taxpayers are protected, the 30-year note exists, and we have a robust—we do not limit the ability to have a robust housing industry moving forward?

Ms. MILLER. Thank you for the question. We certainly welcome the development of bipartisan housing finance reform legislation, so we will carefully follow the progress on this. And I think we have been pretty clear that we want to wind down the GSEs in a responsible manner at the same time that we protect access to credit for Americans who need home mortgage credit. And we think that the proposals that we have seen, some of the white papers that are now circulating on the backs of improvement in the housing market, which is clearly a precedent for moving forward with housing finance reform, are very useful and supportive of many of the principles that we have already established.

Senator TESTER. I appreciate that and I appreciate both your comments and Governor Tarullo's, and thank you all for being here today. Thank you, Mr. Chairman.

Chairman JOHNSON. Thank you.

I understand that Senator Crapo has some questions that will be submitted for the panel.

I want to thank today's witnesses for their testimony and their continued focus on a safe and stable financial system.

This hearing is adjourned.

[Whereupon, at 12:22 p.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

PREPARED STATEMENT OF MARY J. MILLER

UNDER SECRETARY FOR DOMESTIC FINANCE, DEPARTMENT OF THE TREASURY

JULY 11, 2013

Chairman Johnson, Ranking Member Crapo, and Members of the Committee, thank you for inviting me to testify today on behalf of the Treasury Department.

Almost 3 years ago, President Obama signed into law a historic set of reforms to make our financial system stronger and more stable. As I testified before the Committee earlier this year, we have made considerable progress toward achieving those objectives through implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act. While additional work remains to be done and we must always remain vigilant to potential emerging risks in financial institutions and markets, we are much closer to the end of this process than the beginning.

Many of the key reforms have already been finalized, with additional pieces falling into place on an ongoing basis. The Consumer Financial Protection Bureau is operational and has taken important steps to provide clarity on financial products for American consumers and rein in unfair, deceptive, and abusive practices. Despite funding constraints, the SEC and CFTC are using the expanded enforcement authority granted under Dodd-Frank. The bank regulatory agencies have just finalized key rules strengthening the quality and quantity of capital that banks are required to hold. A new framework for regulatory oversight of the over-the-counter derivatives market is largely in place, with swap dealers registering with the CFTC and certain interest-rate and credit-index swap transactions moving to central clearinghouses, reducing overall risk to the financial system.

The public is already beginning to see the benefits of reform through a safer and stronger financial system and a broader economic recovery. Although the financial markets have recovered more strongly than the overall economy, the economic recovery is gaining traction. Private sector payrolls have increased by more than 7 million jobs from the low point in February 2010, marking the 40th consecutive month of private-sector job growth. The unemployment rate, while still too high at 7.6 percent, has fallen almost 2.5 percentage points since its October 2009 peak of 10 percent. The recovery in the housing market appears to be taking firm hold as measured by rising home prices, stronger sales, and a declining number of delinquencies and defaults.

Although we have made good progress, we must intensify our efforts to complete the remaining pieces of financial reform as quickly as possible and stand ready to identify and respond to new threats to financial stability. We must also continue to work with our international counterparts to promote strong and consistent global approaches to financial regulation and encourage them to move swiftly toward the completion and implementation of key reforms in their jurisdictions.

I would like to update the Committee on several important regulatory developments since I appeared before you in February. In April, the Financial Stability Oversight Council released its 2013 annual report, which both identified potential emerging threats to financial stability and made recommendations to enhance the stability of the financial system. In May, Secretary Lew testified before this Committee on the Council's report.

At the beginning of June, the Financial Stability Oversight Council voted to make proposed designations of an initial set of nonbank financial companies under section 113 of the Dodd-Frank Act. Companies subject to a proposed designation had 30 days to request a hearing prior to the Council making a final determination. Earlier this week, the Council made final designations of two companies in this initial set that did not request hearings, American International Group, Inc. and General Electric Capital Corporation, Inc. With respect to one other company currently subject to a proposed designation that requested a hearing, the hearing will be conducted no later than early August with a final decision by the Council no later than the beginning of October. This is an ongoing process, and the Council will continue to evaluate other companies for potential designation.

The Council's work on the designation of nonbank financial companies helps put us in a better position to address potential threats to the financial system. Large, complex nonbank financial companies that the Council determines could pose a threat to U.S. financial stability will be supervised on a consolidated basis by the Board of Governors of the Federal Reserve System and subject to capital requirements and other enhanced prudential standards.

Last week, the Federal Reserve finalized an important set of rules codifying the Basel capital requirements for banks and bank holding companies, and the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency followed suit earlier this week. Also, the banking regulators proposed a leverage re-

quirement earlier this week as a companion to the Basel capital requirement, which is necessary to further the cause of safety and soundness in the financial system. I will defer to my colleagues on the panel to discuss the details of these rules, but the progress we have made on both a significantly stronger capital regime and the expansion of the supervisory umbrella to cover designated nonbank financial companies are key developments in making our financial system more resilient and protecting the American economy from the harm of another crisis.

In February, I also highlighted the Council's work on money market mutual fund reform. At the end of 2012, the Council issued proposed recommendations on money fund reforms for public comment. The comment period on those recommendations closed shortly after I testified. In its annual report, the Council recommended that the SEC consider the views expressed by commenters on the Council's proposed recommendations. Throughout this process, we have made it clear that the SEC is the primary regulator and should take the lead in driving reforms. In June, the Securities and Exchange Commission proposed regulations that are intended to reduce the risks presented by money funds. This is an important next step in the process. Public comments on the SEC's proposal will provide important feedback and information for the SEC to consider in developing a final rule.

In June, Treasury's Federal Insurance Office released its first annual report on the insurance industry. The report examines the principal sectors of the insurance industry, reviews key legal and regulatory developments affecting the insurance industry in the United States and internationally, and discusses current and emerging trends that could significantly impact the industry and the stability of the U.S. financial system. The Federal Insurance Office has also been working to complete its report on the modernization and improvement of the system of insurance regulation in the United States.

In addition, the Federal Insurance Office is working on the international front to represent U.S. interests in the development of international insurance standard-setting and financial stability activities. The Office has worked and will continue to work closely and consult with State insurance regulators on these efforts. The Office has been involved in the work of the International Association of Insurance Supervisors to develop the methodology for the identification of global systemically important insurers (G-SIIs) and the policy measures to be applied to any designated G-SII. The Federal Insurance Office's international involvement has played an important complementary role to the progress that the Financial Stability Oversight Council has made domestically in the designation of nonbank financial companies.

I would also like to highlight for the Committee a few areas where Treasury intends to direct significant attention and resources during the remainder of the year to complete key outstanding pieces of reform. Secretary Lew, in his capacity as Chairperson of the Council, is responsible for coordinating the regulations issued by the five rule-making agencies—the Federal Reserve, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Securities and Exchange Commission, and the Commodity Futures Trading Commission—to implement Section 619 of the Dodd-Frank Act, commonly referred to as the Volcker Rule. Starting from his first day in office, Secretary Lew has convened meetings with the heads of the rule-making agencies to stress the importance of finishing work on the Volcker Rule. Finalizing the regulations will continue to be a top priority for the Secretary and the Treasury Department. Successful completion of this work will impose needed limits on banks' ability to engage in speculative trading activities and relationships with private equity and hedge funds for their own benefit rather than for the benefit of their customers.

Secretary Lew is similarly responsible for coordinating the rules to implement Section 941 of the Dodd-Frank Act. The risk-retention rule generally requires issuers of asset-backed securities to retain an interest in the asset-backed securities they sell to third parties. Staff from Treasury, the bank regulatory agencies, the Federal Housing Finance Agency, the Department of Housing and Urban Development, and the SEC have met regularly to review comments, analyze data, and coordinate on drafting the rule. Completion of these regulations is a priority for the Treasury Department and in particular Secretary Lew, who convened the heads of the rule-making agencies to discuss work on these rules last month.

Treasury will also continue to engage closely with our regulatory counterparts in the United States and internationally to strengthen our ability to wind down failing financial companies while minimizing the negative impact on the rest of the financial system and the economy. The bankruptcy process, aided by the Dodd-Frank Act's living wills requirement, continues to be the preferred method for resolving failing financial companies. All of the firms that are required to submit living wills will have done so by the end of this year, and the largest 11 bank holding companies

will submit their second round of living wills this fall, providing an additional tool to facilitate their orderly resolution through bankruptcy should they fail.

However, in the case where bankruptcy is unable to resolve a failing company without imposing serious adverse effects on U.S. financial stability, the Dodd-Frank Act's orderly liquidation authority provides critical new authorities to allow firms to fail, no matter how large and complex. Treasury, the Federal Reserve, the FDIC, and other financial regulatory agencies will continue to engage in extensive preparations and conduct rigorous planning exercises and simulations to be fully prepared to wind down any financial company whose failure could threaten the stability of our system. In these simulations, the agencies have focused on resolving a company consistent with Dodd-Frank's important requirement that no taxpayer funds shall be used to prevent the liquidation of a financial company. Moreover, the law requires that losses be borne by creditors and shareholders of the company and, if necessary, the financial sector. This means that taxpayers will bear none of the losses.

Treasury and the regulators will also continue to closely collaborate with our international counterparts through forums like the Financial Stability Board and on a bilateral basis to address obstacles to resolving large, cross-border firms. One example is the FDIC's recently signed memoranda of understanding with its counterparts in Canada and the United Kingdom defining the scope of information-sharing and cooperation in resolving internationally active insured depository institutions and certain other financial companies. Continued diligence and progress on this front will be essential to making the orderly liquidation authority an effective and reliable tool for winding down a failing company and mitigating threats to U.S. financial stability.

The Dodd-Frank Act provides valuable new authorities to help protect our financial system. The Financial Stability Oversight Council's mission is to identify and respond to emerging threats to the stability of the United States financial system. It is actively carrying out those duties, as reflected both in its annual reports that it submits to Congress and its activities such as the designation of nonbank financial companies. Living wills and stress tests are the new rules of the road for bank holding companies, providing the companies, regulators, the marketplace, and the public with valuable information they previously lacked. These are not just one-time requirements. They are conducted on an annual or semi-annual basis, which will provide information about discrete points in time as well as long-term comparisons.

By the end of this year, we expect to approach the point of substantial completion of implementation of the Dodd-Frank Act. That does not mean we will be able to relax our guard. Constant evolution in the financial system and the activities of financial institutions will require regulators to be flexible and ready to address new threats to the financial system.

PREPARED STATEMENT OF DANIEL K. TARULLO

GOVERNOR, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

JULY 11, 2013

Chairman Johnson, Ranking Member Crapo, and other Members of the Committee, thank you for the opportunity to testify on the Federal Reserve's activities in mitigating systemic risk and implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act).

With the third anniversary of the Dodd-Frank Act upon us, it is a good time to reflect on what has been accomplished, what still needs to be done, and how the work on the Dodd-Frank Act fits with other regulatory reform projects. Indeed, the deliberate pace and multipronged nature of the implementation of the act—occasioned as it is by complicated issues and decision-making processes—may be obscuring what will be far-reaching changes in the regulation of financial firms and markets. Indeed, the Federal Reserve and other banking supervisors have already created a very different supervisory environment than what was prevalent just a few years ago.

Today, I will review recent progress in key areas of financial regulatory reform, with special—though not exclusive—attention to implementation of the Dodd-Frank Act, including how that law affects the regulation of community banks. I will also highlight areas in which proposals are still outstanding and, in a few cases, in which we intend to make new proposals in the relatively near future.

Implementation of Basel III Capital Rules

Let me begin by noting the completion of our major rulemakings on capital regulation. Although most of the provisions in these rules do not directly implement pro-

visions of the Dodd-Frank Act, implementation of that law is occurring against the backdrop of implementation of the Basel III framework.

This month, the Federal Reserve, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (FDIC) approved final rules implementing the Basel III capital framework, as well as certain related changes required by the Dodd-Frank Act.¹ The rules establish an integrated regulatory capital framework designed to ensure that U.S. banking organizations maintain strong capital positions, enabling them to absorb substantial losses on a going-concern basis and to continue lending to creditworthy households and businesses even during economic downturns.

The rules increase the quantity and improve the quality of regulatory capital of the U.S. banking system by setting strict eligibility criteria for regulatory capital instruments, by raising the minimum tier 1 capital ratio from 4 percent to 6 percent of risk-weighted assets, and by establishing a new minimum common equity tier 1 capital ratio of 4.5 percent of risk-weighted assets. The rules also require a capital conservation buffer of 2.5 percent of risk-weighted assets to ensure that banking organizations build capital during benign economic periods so that they can withstand serious economic downturns and still remain above the minimum capital levels. In addition, the rules improve the methodology for calculating risk-weighted assets to enhance risk sensitivity and incorporate certain provisions of the Dodd-Frank Act, such as sections 171 and 939A.² The rules also contain certain provisions, including a supplementary leverage ratio and a countercyclical capital buffer, that apply only to large and internationally active banking organizations, consistent with their systemic importance and their complexity. The rules will have several important consequences.

First, they consolidate the progress made by banks and regulators over the past 4 years in improving the quality and quantity of capital held by banking organizations. Second, they remedy shortcomings in our existing generally applicable risk-weighted asset calculations that became apparent during the financial crisis. In so doing, they also enhance the effectiveness of the Collins Amendment, the scope of which we have extended through these rules by applying standardized floors to capital buffer, as well as minimum requirements. Third, adoption of these rules meets international expectations for U.S. implementation of the Basel III capital framework. This gives us a firm position from which to press our expectations that other countries implement Basel III fully and faithfully.

In crafting these rules, the banking agencies made a number of changes to the 2012 proposals, mostly to address concerns by community banks. For example, the new rules maintain current practice on risk weighting residential mortgages and provide community banking organizations the option of maintaining existing standards on the regulatory capital treatment of “accumulated other comprehensive income” (AOCI) and preexisting trust preferred securities. These changes from the proposed rule are meant to reduce the burden and complexity of the rules for community banks while preserving the benefits of more rigorous capital standards. Most banking organizations already meet the higher capital standards, and the rules will help preserve the benefits of the stronger capital positions banks have built under the oversight of regulators since the financial crisis.

The capital rules also apply risk-based and leverage capital requirements to certain savings and loan holding companies for the first time. In another change from the proposal, savings and loan holding companies with significant commercial and insurance underwriting activities will not be subject to the final rules at this time. During the comment period, these firms raised significant concerns regarding the appropriateness of the proposed regulatory capital framework for their business models. To address these concerns, the Federal Reserve will take additional time to evaluate the appropriate regulatory capital framework for these entities.

All financial institutions subject to the new rules will have a significant transition period to meet the requirements. The phase-in period for smaller, less complex banking organizations will not begin until January 2015, while the phase-in period for larger institutions begins in January 2014.

¹ See, www.federalreserve.gov/newsevents/press/bcreg/20130702a.htm.

² Section 171 of the Dodd-Frank Act, commonly referred to as the Collins Amendment, requires the Federal banking agencies to establish minimum risk-based and leverage capital requirements for bank holding companies, savings and loan holding companies, insured depository institutions, and nonbank financial holding companies designated by the Financial Stability Oversight Council for supervision by the Federal Reserve. Under section 171, among other things, these minimum capital requirements may not be less than, nor quantitatively lower than, the generally applicable capital requirements that were in effect for insured depository institutions on the date of enactment of the Dodd-Frank Act. Section 939A requires all Federal agencies to remove references to credit ratings in their regulations, including the capital rules.

Stress Testing and Capital Planning Requirements for Large Banking Firms

Important as higher capital requirements and a better quality of capital are to the safety and soundness of financial institutions, conventional capital requirements are by their nature somewhat backward-looking. First, they reflect loss expectations based on past experience. Second, losses that actually reduce reported capital levels are often formally taken by institutions well after the likelihood of losses has become clear. Rigorous stress testing helps compensate for these shortcomings through a forward-looking assessment of the losses that would be suffered under stipulated adverse economic scenarios, so that capital can be built and maintained at levels high enough for the firms to withstand such losses and still remain viable financial intermediaries. In the middle of the financial crisis, the Federal Reserve created and applied a stress test to the Nation's largest financial firms. The next year, Congress mandated stress tests for a larger group of firms in the Dodd-Frank Act. This fall, we will extend the full set of stress testing requirements to the dozen or so banking organizations with greater than \$50 billion in assets covered in the Dodd-Frank Act but not fully covered in our previous stress tests.

Regular, comprehensive stress testing, with published results, has already become a key part of both capital regulation and overall prudential supervision. In the annual Comprehensive Capital Analysis and Review (CCAR), the Federal Reserve requires each large bank holding company to demonstrate that it has rigorous, forward-looking capital planning processes that effectively account for the unique risks of the firm and maintains sufficient capital to continue to operate through times of extreme economic and financial stress. CCAR and Dodd-Frank Act stress tests have shown the significant supervisory value of conducting coordinated cross-firm analysis of the major risks facing large banks.

The Federal Reserve has used stress testing and its broader supervisory authority to prompt a doubling over the past 4 years of the common equity capital of the Nation's 18 largest bank holding companies, which collectively hold more than 70 percent of the total assets of all U.S. bank holding companies. Specifically, the aggregate tier 1 common equity ratio—which is based on the strongest form of loss-absorbing capital—at the 18 firms covered by the stress test has more than doubled, from 5.6 percent at the end of 2008 to 11.3 percent at the end of 2012. That reflects an increase in tier 1 common equity from \$393 billion to \$792 billion during the same period.

Enhanced Prudential Requirements for Large Banking Firms

Sections 165 and 166 of the Dodd-Frank Act require the Federal Reserve to establish a broad set of enhanced prudential standards, both for bank holding companies with total consolidated assets of \$50 billion or more and for nonbank financial companies designated by the Financial Stability Oversight Council (Council) as systemically important. The required standards include capital requirements, liquidity requirements, stress testing, single-counterparty credit limits, an early remediation regime, and risk-management and resolution-planning requirements. The sections also require that these prudential standards become more stringent as the systemic footprint of a firm increases.

The Federal Reserve has issued proposed rules to implement sections 165 and 166 for both large U.S. banking firms and foreign banks operating in the United States. In addition, earlier this week the Federal banking agencies jointly issued a proposal to implement higher leverage ratio standards for the largest, most systemically important U.S. banking organizations. We have already finalized the rules on resolution planning and stress testing, and we are working diligently this year toward finalization of the remaining standards.

On liquidity, we will also be implementing the Basel III quantitative liquidity requirements for large U.S. banking firms. We expect that the Federal banking agencies will issue a proposal later this year to implement the Basel Committee's Liquidity Coverage Ratio for large U.S. banking firms. These quantitative liquidity requirements would complement the stricter set of qualitative liquidity standards that the Federal Reserve has already proposed pursuant to section 165 of the Dodd-Frank Act.

On capital, we will be proposing risk-based capital surcharges on the most systemically important U.S. banking firms. The proposal will be based on the risk-based capital surcharge framework developed by the Basel Committee for global systemically important banks, under which the size of the surcharge will increase with a banking firm's systemic importance. These surcharges are a critical element of the Federal Reserve's efforts to force the most systemic financial firms to internalize the externalities caused by their potential failure and to reduce any residual subsidies such firms may enjoy as a result of market perceptions that they may be too big

to fail. We anticipate issuing a proposed regulation on these capital surcharges around the end of this year.

With one exception, we expect to finalize the remaining proposed enhanced prudential standards around the end of the year as well. The one exception is single-counterparty credit limits. We are conducting a quantitative impact study (QIS) on the effects of the counterparty credit limits included in the proposed rule. Based on the comments received and ongoing internal staff analysis, we concluded that a QIS was needed to help us better assess the optimal structure of the rule. Moreover, since the Federal Reserve issued its single-counterparty credit limit proposal, the Basel Committee began developing a similar large exposure regime that would apply to all global banks. We are coordinating our single-counterparty credit limit rule with this effort.

A core element of the Federal Reserve's proposed enhanced prudential standards for large banking firms is our December 2012 foreign bank proposal. The foreign bank proposal responds to fundamental changes over the last 15 years in the scope and scale of the U.S. operations of foreign banking organizations, many of which have moved beyond their traditional lending activities to engage in substantial capital markets activities and, in some cases, have become more reliant on short-term wholesale U.S. dollar funding. The proposed rule would increase the resiliency of the U.S. operations of foreign banks and help protect U.S. financial stability. The proposal would also promote competitive equality for all large banking firms—domestic and foreign—operating in the United States and would, in many respects, result in greater harmony between how the U.S. operations of foreign banking organizations and the foreign operations of U.S. bank holding companies are regulated.

The foreign bank proposal generally would require foreign banks with a large U.S. presence to organize their U.S. subsidiaries under a single U.S. intermediate holding company that would serve as a platform for consistent supervision and regulation. The U.S. intermediate holding companies of foreign banks would be subject to the same risk-based capital and leverage requirements as U.S. bank holding companies. In addition, U.S. intermediate holding companies and the U.S. branches and agencies of foreign banks with a large U.S. presence would be required to meet liquidity requirements similar to those applicable to large U.S. bank holding companies. Importantly, however, the foreign bank proposal does not entail full subsidiarization—foreign banks generally will continue to be allowed to directly branch into the United States on the basis of their consolidated capital. The comment period for this proposal closed at the end of April, and we are now carefully reviewing comments.

Improving Resolvability of Large Banking Firms

An important reform included in the Dodd-Frank Act was the creation of the Orderly Liquidation Authority (OLA). Under OLA, the FDIC can resolve a systemic financial firm by imposing losses on the shareholders and creditors of the firm and replacing its management, while preserving the operations of the sound, functioning parts of the firm. This authority gives the Government a real alternative to the Hobson's choice of bailout or disorderly bankruptcy that authorities faced in 2008. Similar resolution mechanisms are under development in other countries, and the Basel Committee and the Financial Stability Board have devoted considerable attention to developing new international standards for statutory resolution frameworks. Although much work remains to be done by all countries, the Dodd-Frank Act reforms have paved the way for the United States to be a leader in shaping the development of international policy on effective resolution regimes for systemic financial firms.

In implementing OLA, the FDIC is developing the single-point-of-entry (SPOE) resolution approach. SPOE is designed to focus losses on the shareholders and long-term unsecured debt holders of the parent holding company of the failed firm. It aims to produce a well-capitalized bridge holding company in place of the failed parent by converting long-term debt holders of the parent into equity holders of the bridge. The critical operating subsidiaries of the failed firm would be recapitalized by the parent, to the extent necessary, and would remain open for business. The SPOE approach should reduce incentives for creditors and customers of the operating subsidiaries to run and, as financial stress increases, for host-country regulators to engage in ring-fencing or other measures disruptive to an orderly, global resolution of the failed firm.

Successful execution by the FDIC of its preferred SPOE approach in OLA depends on the availability of a sufficient combined amount of equity and loss-absorbing debt at the parent holding company of the failed firm. Accordingly, in consultation with the FDIC, the Federal Reserve is working on a regulatory proposal that requires the largest, most complex U.S. banking firms to maintain a minimum amount of outstanding long-term unsecured debt on top of their regulatory capital require-

ments. Such a requirement could have a number of public policy benefits. Most notably, it would increase the prospects for an orderly resolution under OLA by ensuring that shareholders and long-term debt holders of a systemic financial firm can bear potential future losses at the firm and sufficiently capitalize a bridge holding company in resolution. In addition, by increasing the credibility of OLA, a minimum long-term debt requirement could help counteract the moral hazard arising from taxpayer bailouts and improve market discipline of systemic firms.

The Dodd-Frank Act also requires that all large bank holding companies develop, and submit to supervisors, resolution plans. The Federal Reserve has been working with the FDIC to review resolution plans submitted by the largest U.S. bank holding companies and foreign banks. The largest firms—generally those with \$250 billion or more in total nonbank assets—submitted their first annual resolution plans to the Federal Reserve and the FDIC in the third quarter of 2012. These “first-wave” resolution plans yielded valuable information that is being used to identify, assess, and mitigate key challenges to resolvability under the Bankruptcy Code and to support the FDIC’s development of backup resolution plans under OLA. These plans also are very useful supervisory tools that have helped the Federal Reserve and the subject firms focus on opportunities to simplify corporate structures and improve management systems in ways that will help the firms be more resilient and efficient, as well as easier to resolve.

Further work is being done on resolution plans this year. On July 1, bank holding companies in the second group—generally those with between \$100 billion and \$250 billion in total nonbank assets—submitted their initial plans to the Federal Reserve. The public portions of these resolution plans were made available on the FDIC and Federal Reserve Web sites on July 2.³ The first-wave filers will submit updated plans in October that reflect further guidance from the FDIC and the Federal Reserve.

Structural Reform of Banking Firms

The Dodd-Frank Act also includes provisions calling for structural reform of the U.S. banking system. Key elements are the Volcker Rule in section 619 of the act and the derivatives push-out provision in section 716 of the act.

The Volcker Rule generally prohibits a banking entity from engaging in proprietary trading or acquiring an ownership interest in, sponsoring, or having certain relationships with a hedge fund or private equity fund. The Federal banking agencies and the Securities and Exchange Commission (SEC) jointly proposed a rule to implement the Volcker Rule in October 2011. The Commodity Futures Trading Commission issued a substantially similar proposal a few months later.

The rule-making agencies have carefully analyzed the nearly 19,000 public comments on the proposal and have made steady and significant progress toward crafting a final rule that attempts to maximize bank safety and soundness and financial stability while minimizing cost to the liquidity of the financial markets, credit availability, and economic growth. The implementation of the Volcker Rule has taken a significant amount of time for a variety of reasons—the interpretive and policy issues implicated by the rule are complex, the completion of the Volcker Rule requires negotiations among a variety of banking and market regulators, and the potential costs of getting the Volcker Rule wrong are high. But I think most observers would agree that the agencies need to provide firms, markets, and the public with the product of all this work, so that they can begin to adjust their plans and expectations accordingly. During this Committee’s last oversight hearing in February, I expressed the hope that we would complete the Volcker Rule by the end of this year. Since that time, there has been good interagency progress, and I maintain both the hope and expectation of 5 months ago.

The derivatives push-out provision in section 716 of the Dodd-Frank Act generally prohibits the provision of Federal assistance, such as FDIC deposit insurance or Federal Reserve discount window credit, to swap dealers and major swap participants. The provision becomes effective on July 16, 2013, although the statute provides insured depository institutions the right to request a 2-year extension from their primary Federal supervisor. Last month, the Federal Reserve issued an interim final rule that clarified that uninsured U.S. branches and agencies of foreign banks will be treated in the same manner as insured depository institutions under section 716 and, as a result, will qualify for the same exemptions and 2-year transition period available by statute to U.S. insured depository institutions. The interim final rule also establishes the process for State member banks and uninsured State branches or agencies of foreign banks to apply to the Federal Reserve for transition

³ See, www.federalreserve.gov/newsevents/press/bcreg/20130702b.htm.

relief.⁴ Although the rule is already effective, we are seeking comments on it and will revise the rule, as necessary, in light of comments received.

Oversight of Community Banks

In addition to overseeing large banking firms, the Federal Reserve supervises approximately 800 State-chartered community banks that are members of the Federal Reserve System.⁵ Community banks play an important role in extending credit in local economies across the country—particularly, though by no means only, in their lending to small and medium-sized businesses. Recognizing the disproportionate burden that regulatory compliance can impose on smaller institutions, the Federal Reserve has put in place special processes for taking account of the circumstances and more limited compliance resources of community banks, while still achieving safety-and-soundness aims. We created a special subcommittee of our regulatory and supervisory oversight committee to review all proposals with an eye to their effects on community banks. We have also established a Community Depository Institutions Advisory Council to enable community bankers to comment on the economy, lending conditions, supervisory policies, and other matters of interest.

The changes we will be seeing in the financial regulatory architecture as a result of the Dodd-Frank Act and Basel III are principally directed at our largest and most complex financial firms. Many of the Basel III requirements will not apply to smaller banks—including the countercyclical capital buffer, supplementary leverage ratio, trading book reforms, AOCI flow through, higher capital requirements for counterparty credit risk on derivatives, and disclosure requirements. In fact, most of the significant changes from the proposed capital rules published by the three banking agencies last year that we made in the final version of the rules issued earlier this month were in response to concerns expressed by smaller banks. Community banking organizations also will not be subject to the Federal Reserve's additional enhanced prudential standards that larger banking firms face or will face, such as capital plans, stress testing, resolution plans, single-counterparty credit limits, and capital surcharges for systemically important financial firms. In addition, most of the major systemic risk and prudential provisions of the Dodd-Frank Act—such as the Volcker Rule, derivatives push-out, derivatives central clearing requirements, and the Collins Amendment—will have a far smaller impact on community banks than on large banking firms.

Constraining Systemic Risk Outside the Banking Sector

While strengthening the regulation and improving the resolvability of banking firms is of paramount importance, we should not forget that one of the key elements of the recent financial crisis was the precipitous unwinding of large amounts of short-term wholesale funding that had been made available to highly leveraged and maturity-transforming financial firms, many of which were clearly outside of the traditional banking sector. Nonbank financial intermediaries can provide substantial benefits to an economy, but a complete financial reform program must address financial stability risks that emanate from the shadow banking system. Particularly as we tighten the oversight of the regulated banking system, it will become more and more essential that we are able to monitor and constrain the build-up of systemic risks in the nonbank financial sector.

Among other things, financial stability depends on strong consolidated supervision and regulation of all financial firms whose failure could pose a threat to the financial system—whether or not they own a bank. One of the key lessons of the financial crisis was the prodigious amount of systemic risk that was concentrated in several nonbank financial firms. To mitigate these risks, the Dodd-Frank Act gave the Council authority to bring systemically important financial firms that are not already bank holding companies within the perimeter of Federal Reserve supervision and regulation. Last month, the Council made three proposed designations of nonbank financial firms, and earlier this week the Council made final designations of two of these firms. The Federal Reserve already supervises these two firms as savings and loan holding companies and we will now begin the process of applying relevant enhanced prudential regulatory and supervisory standards. We remain committed to applying a supervisory and regulatory framework to such firms that is tailored to their business mix, risk profile, and systemic footprint—consistent with the Collins Amendment and other legal requirements under the Dodd-Frank Act.

⁴For approvals granted by the Board for the 2-year transition period, *see*, www.federalreserve.gov/bankinfo/reg/716f-requests.htm.

⁵For supervisory purposes, community banks are generally defined as those with less than \$10 billion in assets.

The threats to financial stability from the shadow banking system do not reside solely in a few individual nonbank financial firms with large systemic footprints. Significant threats to financial stability emanate from systemic classes of nonbank financial firms and from vulnerabilities intrinsic to short-term wholesale funding markets. Many of the key problems related to shadow banking and their potential solutions are still being debated domestically and internationally, but some of the necessary steps are already clear.

First, we need to increase the transparency of shadow banking markets so that authorities can monitor for signs of excessive leverage and unstable maturity transformation outside regulated banks. Since the financial crisis, the ability of the Federal Reserve and other regulators to track the types of transactions that are core to shadow banking activities has improved markedly. But there remain several areas, notably involving transactions organized around an exchange of cash and securities, where gaps still exist. For example, many repurchase agreements and securities lending transactions can still only be monitored indirectly. Improved reporting in these areas would better enable regulators to detect emerging risks in the financial system.

Second, we need to reduce further the risk of runs on money market mutual funds. Late last year, the Council issued a proposed recommendation on this subject that offered three reform options. Last month, the SEC issued a proposal that includes a form of the floating net asset value (NAV) option recommended by the Council.

Third, we need to be sure that initiatives to enhance the resilience of the triparty repo market are successfully completed. These marketwide efforts have been underway for some time and have already reduced discretionary intraday credit extended by the clearing banks by approximately 25 percent. Market participants, with the active encouragement of the Federal Reserve and other supervisors, are on track to achieve the practical elimination of all such intraday credit in the triparty settlement process by the end of 2014.

Completing these three reforms would represent a strong start to the job of reducing systemic risk in the short-term wholesale funding markets that are key to the functioning of securities markets. Still, important work would remain. For example, a major source of unaddressed risk emanates from the large volume of short-term securities financing transactions (SFTs) in our financial system, including repos, reverse repos, securities borrowing, and lending transactions. Regulatory reform has mostly passed over these transactions because SFTs appear to involve minimal risks from a microprudential perspective. But SFTs, particularly large matched books of SFTs, create sizable macroprudential risks, including vulnerabilities to runs and asset fire sales. Although the Dodd-Frank Act provides additional tools to address the failure of a systemically important broker-dealer, the existing bank and broker-dealer regulatory regimes have not been designed to materially mitigate these systemic risks. Continued attention to these potential vulnerabilities is needed, both here in the United States and abroad.

Conclusion

As I hope is apparent from this review of progress on the implementation of regulatory reforms, we are at the beginning of the end of the rule-making process for most of the major Dodd-Frank Act provisions. Some regulations already finalized are now in effect. Others provide a transition period for firms and markets to prepare for the new rules of the road. Still others will be completed in the coming months. With respect to all three sets of regulations, the emphasis will soon be shifting from rule-writing to rule compliance, interpretation, and enforcement. Here, the benchmarks for progress and performance are less visible, at least until something goes wrong. For that reason, it is all the more important that the regulatory agencies put in place institutional mechanisms to assure strong, sensible oversight of the new regulatory framework.

Thank you for your attention. I would be pleased to answer any questions you might have.

**List of Rules, Notices, and Reports
Of the Federal Reserve Board under the Dodd-Frank Act
As of July 2, 2013**

Final Rules and Federal Register Notices:

1. Final rule to implement Basel III capital standards, including standardized risk-weighting and application of advanced approaches risk-based capital rule and market risk capital rule to certain banking organizations & SLHCs
2. Interim final rule regarding applicability of swaps push-out provision to uninsured U.S. branches and agencies of FBOs
3. Final rule on retail FX transactions for Fed-regulated banks
4. Final rule to provide Title I definition for potential SIFI designation
5. Joint final rule with CFPB, FDIC, FHFA, NCUA, and OCC to implement real estate appraisal requirements for higher-risk mortgages
6. Final rule to implement supervisory and company-run stress test requirements for BHCs with \$50 billion or more in assets and nonbank SIFIs supervised by the Fed
7. Final rule to implement annual company-run stress test requirements for banking organizations with over \$10 billion in assets supervised by the Fed, not covered already
8. Final rule to implement risk-management standards and advance notice requirements for FMUs designated as systemically important
9. Final rule to implement debit card interchange fees fraud prevention adjustment
10. Joint final rule with FDIC and OCC to include credit rating alternatives in market risk capital rules
11. Final rule to implement securities holding company registration procedures
12. Notice to implement SLHC reporting requirements
13. Final rule requiring annual capital plans for top tier U.S. BHCs and providing stress testing instructions for the Comprehensive Capital Analysis and Review
14. Joint final rule with FDIC to implement "living will" resolution plan requirement
15. Board rule temporarily exempting motor vehicle dealers from Reg. B data collection requirements
16. Interim final rule regarding regulations applicable to SLHCs (Reg. LL and MM)
17. Notice on OTS regulations to be continued
18. Final rule to repeal Reg. Q (interest on demand deposits)
19. Joint final rule with FTC to revise the content requirements for risk-based pricing notices under the Fair Credit Reporting Act (Reg. V)
20. Final rule amending Reg. B to include the disclosure of credit scores in connection with adverse actions
21. Final rule on debit card interchange fees and prohibition on network exclusivity arrangements and routing restrictions
22. Joint final rule with FDIC and OCC implementing Collins Amendment capital floors
23. Notice regarding application of consolidated supervision program to SLHCs
24. Final rule to increase exemption threshold under Reg. Z Truth In Lending Act
25. Final rule to increase exemption threshold under Reg. M Consumer Leasing Act
26. Final rule to expand coverage under Reg. Z Truth In Lending Act
27. Final rule to expand coverage under Reg. M Consumer Leasing Act
28. Final rule revising Reg. Z Truth in Lending escrow account requirements, including increase to APR threshold for establishing escrow accounts
29. Final rule on Volcker rule conformance period
30. Notice of intent for reporting requirements for SLHCs
31. Interim final rule regarding real estate appraiser independence

ATTACHMENT

Proposed Rules:

1. Proposed rule to implement supervisory assessment fees
2. Proposed rule to implement Federal Reserve accounts & services for designated financial market utilities (FMUs)
3. Proposed rule to implement FBO enhanced prudential standards
4. Jointly proposed rule with FinCEN to amend Bank Secrecy Act definitions resulting from DFA amendments to EFTA
5. Proposed rule to implement enhanced prudential standards addressing capital, liquidity, credit exposure, stress testing, risk management, and early remediation requirements; two stress testing final rules were issued separately on 10/9/12
6. Jointly proposed rule with FDIC, OCC, and SEC to implement Volcker Rule activity restrictions
7. Proposed rule to require remittance transfer providers to make certain disclosures under Reg. E
8. Proposed rule to require creditor to determine a consumer's ability to repay mortgage before making loan under TILA (Reg. Z)
9. Jointly proposed rule with FCA, FDIC, FHFA, and OCC to establish margin and capital requirements for covered swap entities
10. Jointly proposed rule with FDIC, FHFA, NCUA, OCC, OTS, and SEC on incentive compensation arrangements
11. Jointly proposed rule with FDIC, FHFA, HUD, OCC, and SEC on credit risk retention
12. Proposed rule on escrow account requirements under the Truth In Lending Act (Reg. Z)

Completed Reports / Studies:

1. Fed Discount Window Lending and Open Market Transactions Disclosure
2. Board and Reserve Bank Congressional reports on OMWI
3. Board Congressional report on credit rating review in regulations
4. Board study on bankruptcy process for financial companies
5. Board study on international coordination of bankruptcy process for SIFIs
6. Board Congressional report on government prepaid cards
7. Joint report with CFTC and SEC on designated clearing entities
8. Board Congressional report on ACH remittance transfers
9. Board report on debit interchange transaction fees
10. Joint report with OTS, FDIC, and OCC on OTS transition plan
11. Board public website disclosure of emergency lending and other facilities
12. Board study on impact of credit risk on securitizations market

Other Rules authorized by Dodd-Frank Act:

1. Financial Sector Concentration Limit
2. Credit Exposure Reporting Requirements (joint with FDIC)
3. Intermediate Holding Company Regulations for Systemically Important Non-bank Financial Companies and Unitary Savings and Loan Holding Companies
4. Safe Harbor Provision to exempt certain types of nonbank financial companies from being systemically important
5. Source of Strength Requirement (joint with FDIC and OCC)
6. Emergency Lending Facilities
7. Amendments to section 23A
8. Real Estate Appraisal Auto Valuation Models (joint with OCC, FDIC, NCUA, FHFA and CFPB)
9. Real Estate Appraisal Management Company Registration (joint with OCC, FDIC, NCUA, FHFA, and CFPB)

PREPARED STATEMENT OF MARTIN J. GRUENBERG

CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

JULY 11, 2013

Chairman Johnson, Ranking Member Crapo, and Members of the Committee, thank you for the opportunity to testify today on the Federal Deposit Insurance Corporation's (FDIC) actions to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

With the 3-year anniversary of the Dodd-Frank Act approaching, the FDIC has made significant progress in implementing the new authorities granted by the Act,¹ particularly with regard to the authorities to address the issues presented by institutions that pose a risk to the financial system. We also have moved forward in our efforts to strengthen the Deposit Insurance Fund and to improve the resiliency of the capital framework for the banking industry.

My written testimony will address three key areas. First, I will provide a brief overview of the current state of the banking industry and the Federal deposit insurance system. Second, I will provide an update on our progress in implementing the new authority provided to the FDIC to address the issues posed by systemically important financial institutions. Finally, I will discuss the Act's impact on our supervision of community banks.

Overview of the Banking Industry

The financial condition of the banking industry in the United States has experienced three consecutive years of gradual but steady improvement. Industry balance sheets have been strengthened and capital and liquidity ratios have been greatly improved.

Industry net income has now increased on a year-over-year basis for 15 consecutive quarters. FDIC-insured commercial banks and savings institutions reported aggregate net income of \$40.3 billion in the first quarter of 2013, a \$5.5 billion (15.8 percent) increase from the \$34.8 billion in profits that the industry reported in the first quarter of 2012. Half of the 7,019 FDIC-insured institutions reporting financial results had year-over-year increases in their earnings. The proportion of banks that were unprofitable fell to 8.4 percent, down from 10.6 percent a year earlier.

Credit quality for the industry also has improved for 12 consecutive quarters. Delinquent loans and charge-offs have been steadily declining for over 2 years. Importantly, loan balances for the industry as a whole have now grown for six out of the last eight quarters. These positive trends have been broadly shared across the industry, among large institutions, midsize institutions, and community banks.

The internal indicators for the FDIC also have been moving in a positive direction over this period. The number of banks on the FDIC's "Problem List"—institutions that had our lowest supervisory CAMELS ratings of 4 or 5—peaked in March of 2011 at 888 institutions. By the end of last year, the number of problem banks stood at 651 institutions, dropping further to 612 institutions at the end of the first quarter 2013. In addition, the number of failed banks has been steadily declining. Bank failures peaked at 157 in 2010, followed by 92 in 2011, and 51 in 2012. To date in 2013, there have been 16 bank failures compared to 31 through the same period in 2012.

Despite these positive trends, the banking industry still faces a number of challenges. For example, although credit quality has been improving, delinquent loans and charge-offs remain at historically high levels. In addition, tighter net interest margins and relatively modest loan growth have created incentives for institutions to reach for yield in their loan and investment portfolios, heightening their vulnerability to interest rate risk and credit risk. Rising rates could heighten pressure on earnings at financial institutions that are not actively managing these risks. The Federal banking agencies have reiterated their expectation that banks manage their interest rate risk in a prudent manner, and supervisors continue to actively monitor this risk.

Condition of the FDIC Deposit Insurance Fund

As the industry has recovered over the past 3 years, the Deposit Insurance Fund (DIF) also has moved into a stronger financial position.

Restoring the DIF

The Dodd-Frank Act raised the minimum reserve ratio for the DIF (the DIF balance as a percent of estimated insured deposits) from 1.15 percent to 1.35 percent,

¹ A summary of the FDIC's progress implementing the provisions of the Dodd-Frank Act is attached to this testimony.

and required that the reserve ratio reach 1.35 percent by September 30, 2020. The FDIC is currently operating under a DIF Restoration Plan that is designed to meet this deadline, and the DIF reserve ratio is recovering at a pace that remains on track under the Plan. As of March 31, 2013, the DIF reserve ratio stood at 0.59 percent of estimated insured deposits, up from 0.44 percent at year-end 2012 and 0.22 percent at March 31 of last year. Most of the first quarter 2013 increase in the reserve ratio can be attributed to the expiration of temporary unlimited deposit insurance coverage for non-interest-bearing transaction accounts under the Act on December 31, 2012.

The fund balance has grown for 13 consecutive quarters and stood at \$35.7 billion at March 31, 2013. This is in contrast to the negative \$21 billion fund balance at its low point at the end of 2009. Assessment revenue and fewer anticipated bank failures have been the primary drivers of the growth in the DIF balance.

Prepaid Assessments

At the end of 2009, banks prepaid to the FDIC more than 3 years of estimated deposit insurance assessments, totaling \$45.7 billion. The prepaid assessments were successful in ensuring that the DIF had adequate liquidity to handle a high volume of bank failures without having to borrow from the Treasury. In accordance with the regulation implementing the prepaid assessment, the FDIC refunded almost \$6 billion in remaining unused balances of prepaid assessments to approximately 6,000 insured institutions at the end of June.

Improving Financial Stability and Mitigating Systemic Risk

Capital Requirements

On July 9, the FDIC Board acted on two important regulatory capital rulemakings. First, the FDIC issued an interim final rule that significantly revises and strengthens risk-based capital regulations through implementation of Basel III. This rule consolidates the proposals issued in the three separate notices of proposed rulemakings (NPRs) that the agencies issued last year and includes significant changes from the original proposals to address concerns raised by community banks. Second, the FDIC issued a joint interagency NPR to strengthen the leverage requirements for systemically important banking organizations.

Interim Final Rule on Basel III

The interim final rule on Basel III would strengthen both the quality and quantity of risk-based capital for all banks by placing greater emphasis on Tier 1 common equity capital. Tier 1 common equity capital is widely recognized as the most loss-absorbing form of capital. The interim final rule adopts with revisions the three notices of proposed rulemakings or NPRs that the banking agencies proposed last year. These are the Basel III NPR, the Basel III advanced approaches NPR, and the so-called Standardized Approach NPR. These changes will create a stronger, more resilient industry better able to withstand environments of economic stress in the future.

This interim final rule is identical in substance to the final rules issued by the Federal Reserve Board and the Office of the Comptroller of the Currency (OCC) and allows the FDIC to proceed with the implementation of these revised capital regulations in concert with our fellow regulators. Issuing the interim final rule also allows us to seek comment on the interactions between the revised risk-based capital regulations and the proposed strengthening of the leverage requirements for the largest and most systemically important banking organizations which is described in more detail below.

During the comment period on these proposals, we received a large number of comments, particularly from community banks, expressing concerns with some of the provisions of the NPRs. The interim final rule makes significant changes to aspects of the NPRs to address a number of these community bank comments. Specifically, unlike the NPR, the rule does not make any changes to the current risk-weighting approach for residential mortgages. It allows for an opt-out from the regulatory capital recognition of accumulated other comprehensive income, or AOCI, except for large banking organizations that are subject to the advanced approaches requirements. Further, the rule reflects that the Federal Reserve has adopted the grandfathering provisions of section 171 of the Dodd-Frank Act for Trust Preferred Securities issued by smaller bank holding companies. Comments received on all these matters were extremely helpful to the agencies in reaching decisions on the proposals.

The interim final rule includes requirements for large banking organizations subject to the advanced approaches requirements that do not apply to community banks. For example, these advanced approach large institutions would be required

to recognize AOCI in regulatory capital and also would face strengthened capital requirements for over-the-counter derivatives.

Consistent with the Basel III international agreement, the interim final rule includes a 3-percent supplementary leverage ratio that applies only to the 16 large banking organizations subject to the advanced approaches requirements. This supplementary leverage ratio is more stringent than the existing U.S. leverage ratio as it would include certain off-balance sheet exposures in its denominator. Given the extensive off-balance sheet activities of many advanced approaches organizations, the supplementary leverage ratio will play an important role. Finally, the rule maintains the existing U.S. leverage requirements for all insured banks, with the minimum leverage requirements continuing to set a floor for the leverage requirements of advanced approaches banking organizations.

Although the new requirements are higher and more stringent than the old requirements, the vast majority of banks meet the requirements of the interim final rule. Going forward, the rule would have the effect of preserving and maintaining the gains in capital strength the industry has achieved in recent years. As a result, banks should be better positioned to withstand periods of economic stress and serve as a source of credit to local communities.

While much contained in these rules does not apply to community banks, we want to be certain that community banks fully understand the changes in the capital rules that do apply to them. To that end, the FDIC is planning an extensive outreach program to assist community banks in understanding the interim final rule and the changes it makes to the existing capital requirements. We will provide technical assistance in a variety of forms, targeted specifically at community banks, including community bank guides on compliance with the rule, a video that will be available on the FDIC Web site, a series of regional outreach meetings, and subject matter experts at each of our regional offices whom banks can contact directly with questions.

Interagency NPR on the Supplementary Leverage Ratio

The FDIC joined the Federal Reserve and the OCC in issuing an NPR which would strengthen the supplementary leverage requirements encompassed in the interim final rule for certain large institutions and their insured banks. Using the NPR's proposed definitions of \$700 billion in total consolidated assets or \$10 trillion in assets under custody to identify large systemically significant firms, the new requirements would currently apply to eight U.S. bank holding companies and to their insured banks.

As the NPR points out, maintenance of a strong base of capital at the largest, most systemically important institutions is particularly important because capital shortfalls at these institutions can contribute to systemic distress and can have material adverse economy effects. Analysis by the agencies suggests that a 3-percent minimum supplementary leverage ratio would not have appreciably mitigated the growth in leverage among these organizations in the years preceding the recent crisis. Higher capital standards for these institutions would place additional private capital at risk before calling upon the DIF and the Federal Government's resolution mechanisms.

The NPR would require these insured banks to satisfy a 6-percent supplementary leverage ratio to be considered well capitalized for prompt corrective action (PCA) purposes. Based on current supervisory estimates of the off-balance sheet exposures of these banks, this would correspond to roughly an 8.6-percent U.S. leverage requirement. For the eight affected banks, this would currently represent \$89 billion in additional capital for an insured bank to be considered well-capitalized.

Bank Holding Companies (BHCs) covered by the NPR would need to maintain supplementary leverage ratios of a 3-percent minimum plus a 2-percent buffer for a 5-percent requirement in order to avoid conservation buffer restrictions on capital distributions and executive compensation. This corresponds to roughly a 7.2-percent U.S. leverage ratio, which would currently require \$63 billion in additional capital.

An important consideration in calibrating the proposal was the idea that the increase in stringency of the leverage requirements and the risk-based requirements should be balanced. Leverage capital requirements and risk-based capital requirements are complementary, with each type of requirement offsetting potential weaknesses of the other. Balancing the increase in stringency of the two types of capital requirement should make for a stronger and sounder capital base for the U.S. banking system.

Resolution of Systemically Important Financial Institutions

In addition to these capital proposals, the FDIC has made progress on policies and strategies to build a more effective resolution framework for large, complex financial

institutions. One of the most important aspects of the Dodd-Frank Act is the establishment of new authorities for regulators to use in the event of the failure of a systemically important financial institution (SIFI).

Resolution Plans—“Living Wills”

Under the framework of the Dodd-Frank Act, bankruptcy is the preferred option in the event of the failure of a SIFI. To make this objective achievable, Title I of the Dodd-Frank Act requires that all bank holding companies with total consolidated assets of \$50 billion or more, and nonbank financial companies that the Financial Stability Oversight Council (FSOC) determines could pose a threat to the financial stability of the United States, prepare resolution plans, or “living wills”, to demonstrate how the company could be resolved in a rapid and orderly manner under the Bankruptcy Code in the event of the company’s financial distress or failure. The living will process is an important new tool to enhance the resolvability of large financial institutions through the bankruptcy process.

The FDIC and the Federal Reserve Board issued a joint rule to implement Section 165(d) requirements for resolution plans (the 165(d) rule) in November 2011. The FDIC also issued a separate rule which requires all insured depository institutions (IDIs) with greater than \$50 billion in assets to submit resolution plans to the FDIC for their orderly resolution through the FDIC’s traditional resolution powers under the Federal Deposit Insurance Act (FDI Act). The 165(d) rule and the IDI resolution plan rule are designed to work in tandem by covering the full range of business lines, legal entities and capital-structure combinations within a large financial firm.

The FDIC and the Federal Reserve review the 165(d) plans and may jointly find that a plan is not credible or would not facilitate an orderly resolution under the Bankruptcy Code. If a plan is found to be deficient and adequate revisions are not made, the FDIC and the Federal Reserve may jointly impose more stringent capital, leverage, or liquidity requirements, or restrictions on growth, activities, or operations of the company, including its subsidiaries. If compliance is not achieved within 2 years, the FDIC and the Federal Reserve, in consultation with the FSOC, can order the company to divest assets or operations to facilitate an orderly resolution under bankruptcy in the event of failure. A SIFI’s plan for resolution under bankruptcy also will support the FDIC’s planning for the exercise of its Title II resolution powers by providing the FDIC with a better understanding of each SIFI’s structure, complexity, and processes.

2013 Guidance on Living Wills

Eleven large, complex financial companies submitted initial 165(d) plans in 2012. Following the review of the initial resolution plans, the agencies developed Guidance for the firms to detail what information should be included in their 2013 resolution plan submissions. The agencies identified an initial set of significant obstacles to rapid and orderly resolution which covered companies are expected to address in the plans, including the actions or steps the company has taken or proposes to take to remediate or otherwise mitigate each obstacle and a timeline for any proposed actions. The agencies extended the filing date to October 1, 2013, to give the firms additional time to develop resolution plan submissions that address the instructions in the Guidance.

Resolution plans submitted in 2013 will be subject to informational completeness reviews and reviews for resolvability under the Bankruptcy Code. The agencies will be looking at how each resolution plan addresses a set of benchmarks outlined in the Guidance which pose the key impediments to an orderly resolution. The benchmarks are as follows:

- *Multiple Competing Insolvencies.* Multiple jurisdictions, with the possibility of different insolvency frameworks, raise the risk of discontinuity of critical operations and uncertain outcomes.
- *Global Cooperation.* The risk that lack of cooperation could lead to ring-fencing of assets or other outcomes that could exacerbate financial instability in the United States and/or loss of franchise value, as well as uncertainty in the markets.
- *Operations and Interconnectedness.* The risk that services provided by an affiliate or third party might be interrupted, or access to payment and clearing capabilities might be lost;
- *Counterparty Actions.* The risk that counterparty actions may create operational challenges for the company, leading to systemic market disruption or financial instability in the United States; and
- *Funding and Liquidity.* The risk of insufficient liquidity to maintain critical operations arising from increased margin requirements, acceleration, termination,

inability to roll over short term borrowings, default interest rate obligations, loss of access to alternative sources of credit, and/or additional expenses of restructuring.

As reflected in the Dodd-Frank Act and discussed above, the preferred option for resolution of a large failed financial firm is for the firm to file for bankruptcy just as any failed private company would. In certain circumstances, however, resolution under the Bankruptcy Code may result in serious adverse effects on financial stability in the United States. In such cases, the Orderly Liquidation Authority set out in Title II of the Dodd-Frank Act serves as the last resort alternative and could be invoked pursuant to the statutorily prescribed recommendation, determination, and expedited judicial review process.

Orderly Liquidation Authority

Prior to the recent crisis, the FDIC's receivership authorities were limited to federally insured banks and thrift institutions. The lack of authority to place the holding company or affiliates of an insured depository institution or any other nonbank financial company into an FDIC receivership to avoid systemic consequences severely constrained the ability to resolve a SIFI. Orderly Liquidation Authority provided under Title II of the Dodd-Frank Act gives the FDIC the powers necessary to resolve a failing systemic nonbank financial company in an orderly manner that imposes accountability on shareholders, creditors and management of the failed company while mitigating systemic risk and imposing no cost on taxpayers.

The FDIC has largely completed the core rulemakings necessary to carry out its systemic resolution responsibilities under Title II of the Dodd-Frank Act. For example, the FDIC approved a final rule implementing the Orderly Liquidation Authority that addressed, among other things, the priority of claims and the treatment of similarly situated creditors.

Under the Dodd-Frank Act, key findings and recommendations must be made before the Orderly Liquidation Authority can be considered as an option. These include a determination that the financial company is in default or danger of default, that failure of the financial company and its resolution under applicable Federal or State law, including bankruptcy, would have serious adverse effects on financial stability in the United States and that no viable private sector alternative is available to prevent the default of the financial company.

To implement its authority under Title II of the Dodd-Frank Act, the FDIC has developed a strategic approach to resolving a SIFI which is referred to as Single Point-of-Entry. In a Single Point-of-Entry resolution, the FDIC would be appointed as receiver of the top-tier parent holding company of the financial group following the company's failure and the completion of the recommendation, determination, and expedited judicial review process set forth in Title II of the Act. Shareholders would be wiped out, unsecured debt holders would have their claims written down to reflect any losses that shareholders cannot cover, and culpable senior management would be replaced. Under the Act, officers and directors responsible for the failure cannot be retained.

During the resolution process, restructuring measures would be taken to address the problems that led to the company's failure. These could include shrinking businesses, breaking them into smaller entities, and/or liquidating certain assets or closing certain operations. The FDIC also would likely require the restructuring of the firm into one or more smaller nonsystemic firms that could be resolved under bankruptcy.

The FDIC would organize a bridge financial company into which the FDIC would transfer assets from the receivership estate, including the failed holding company's investments in and loans to subsidiaries. Equity, subordinated debt, and senior unsecured debt of the failed company would likely remain in the receivership and be converted into claims. Losses would be apportioned to the claims of former equity holders and unsecured creditors according to their order of statutory priority. Remaining claims would be converted, in part, into equity that will serve to capitalize the new operations, or into new debt instruments. This newly formed bridge financial company would continue to operate the systemically important functions of the failed financial company, thereby minimizing disruptions to the financial system and the risk of spillover effects to counterparties.

The healthy subsidiaries of the financial company would remain open and operating, allowing them to continue business and avoid the disruption that would likely accompany their closings. Critical operations for the financial system would be maintained. However, creditors at the subsidiary level should not assume that they avoid risk of loss. For example, if the losses at the financial company are so large that the holding company's shareholders and creditors cannot absorb them, then the

subsidiaries with the greatest losses would have to be placed into resolution, thus exposing those subsidiary creditors to loss.

The FDIC expects the well-capitalized bridge financial company and its subsidiaries to borrow in the private markets and from customary sources of liquidity. The new resolution authority under the Dodd-Frank Act provides a back-up source for liquidity support, the Orderly Liquidation Fund (OLF). If it is needed at all, the FDIC anticipates that this liquidity facility would only be required during the initial stage of the resolution process, until private funding sources can be arranged or accessed. The law expressly prohibits taxpayer losses from the use of Title II authority.

In our view, the Single Point-of-Entry strategy holds the best promise of achieving Title II's goals of holding shareholders, creditors and management of the failed firm accountable for the company's losses and maintaining financial stability at no cost to taxpayers.

Statement of Policy

Informing capital markets, financial institutions, and the public on what to expect if the Orderly Liquidation Authority were to be invoked is an ongoing effort. While the FDIC has already been highly transparent in our planning efforts, we also are currently working on a Statement of Policy which would provide more clarity on the resolution process. We anticipate the release of a proposal for public comment before the end of the year.

In addition, the Federal Reserve, in consultation with the FDIC, is considering the merits of a regulatory requirement that the largest, most complex U.S. banking firms maintain a minimum amount of unsecured debt at the holding company level. Such a requirement would ensure that there are creditors at the holding company level to absorb losses at the failed firm. Questions surrounding a debt requirement are complex and include issues on the amount, seniority structure, and its relation to equity capital.

Cross-Border Issues

Advance planning and cross border coordination for the resolution of globally active, systemically important financial institutions (G-SIFIs) will be critical to minimizing disruptions to global financial markets. Recognizing that G-SIFIs create complex international legal and operational concerns, the FDIC is actively reaching out to foreign host regulators to establish frameworks for effective cross-border cooperation and the basis for confidential information sharing, among other initiatives.

As part of our bilateral efforts, the FDIC and the Bank of England, in conjunction with the prudential regulators in our respective jurisdictions, have been working to develop contingency plans for the failure of G-SIFIs that have operations in both the U.S. and the U.K. Of the 28 G-SIFIs designated by the Financial Stability Board (FSB) of the G20 countries, four are headquartered in the U.K., and another eight are headquartered in the U.S. Moreover, approximately 70 percent of the reported foreign activities of the eight U.S. G-SIFIs emanates from the U.K. The magnitude of these financial relationships makes the U.S.-U.K. bilateral relationship by far the most significant with regard to the resolution of G-SIFIs. As a result, our two countries have a strong mutual interest in ensuring that, if such an institution should fail, it can be resolved at no cost to taxpayers and without placing the financial system at risk. The FDIC and U.K. authorities released a joint paper on resolution strategies in December 2012, reflecting the close working relationship between the two authorities. This joint paper focuses on the application of "top-down" resolution strategies for a U.S. or a U.K. financial group in a cross-border context and addresses several common considerations to these resolution strategies.

In addition to the close working relationship with the U.K., the FDIC is coordinating with representatives from other European regulatory bodies to discuss issues of mutual interest including the resolution of European G-SIFIs. The FDIC and the European Commission (E.C.) have established a joint Working Group comprised of senior executives from the FDIC and the E.C. The Working Group convenes formally twice a year—once in Washington, once in Brussels—with ongoing collaboration continuing in between the formal sessions. The first of these formal meetings took place in February 2013. Among the topics discussed at this meeting was the E.C.'s proposed Recovery and Resolution Directive, which would establish a framework for dealing with failed and failing financial institutions. The overall authorities outlined in that document have a number of parallels to the SIFI resolution authorities provided here in the U.S. under the Dodd-Frank Act. The next meeting of the Working Group will take place in Brussels later this year.

The FDIC also is engaging with Switzerland, Germany, Japan, and Canada on a bilateral basis. Among other things, the FDIC has further developed its understanding of the Swiss resolution regime for G-SIFIs, including an in-depth examination of the two Swiss-based G-SIFIs with significant operations in the U.S. During the past year, we also have participated in several productive workshops with the Federal Financial Supervisory Authority (BaFin), the German resolution authority. The FDIC anticipates a principals-level meeting with Japan later this year.

To place these working relationships in perspective, the U.S., the U.K., the European Union, Switzerland and Japan account for the home jurisdictions of 27 of the 28 G-SIFIs designated by the Financial Stability Board (FSB) of the G20 in November 2012. Progress in these cross-border relationships is thus critical to addressing the international dimension of SIFI resolutions.

The Volcker Rule

The Dodd-Frank Act requires the Securities and Exchange Commission (SEC), the Commodities Futures Trading Commission (CFTC), and the Federal banking agencies to adopt regulations generally prohibiting proprietary trading and certain acquisitions of interest in hedge funds or private equity funds. The FDIC, jointly with the FRB, OCC, and SEC, published an NPR requesting public comment on a proposed regulation implementing the prohibition against proprietary trading. The CFTC separately approved the issuance of its NPR to implement the Volcker Rule, with a substantially identical proposed rule text.

The proposed rule also requires banking entities with significant covered trading activities to furnish periodic reports with quantitative measurements designed to help differentiate permitted market-making-related activities from prohibited proprietary trading. Under the proposed rule, these requirements contain important exclusions for banking organizations with trading assets and liabilities less than \$1 billion, and reduced reporting requirements for organizations with trading assets and liabilities of less than \$5 billion. These thresholds are designed to reduce the burden on smaller, less complex banking entities, which generally engage in limited market-making and other trading activities.

The agencies are evaluating a large body of comments on whether the proposed rule represents a balanced and effective approach or whether alternative approaches exist that would provide greater benefits or implement the statutory requirements with fewer costs. The FDIC is committed to developing a final rule that meets the objectives of the statute while preserving the ability of banking entities to perform important underwriting and market-making functions, including the ability to effectively carry out these functions in less-liquid markets. Most community banks do not engage in activities that would be impacted by the proposed rule.

The Dodd-Frank Act and Community Banks

While the Dodd-Frank Act has changed the regulatory framework for the financial services industry, many of the Act's reforms are geared toward larger institutions, as discussed above. At the same time, the Act included a number of provisions that impacted community banks. Of particular relevance to the FDIC, the Act made changes to the deposit insurance system that have specific consequences for community banks.

In the aftermath of the crisis, the Dodd-Frank Act made permanent the increase in the coverage limit to \$250,000, a provision generally viewed by community banks as a helpful means to attract deposits.

The FDIC also implemented the Dodd-Frank Act requirement to redefine the base used for deposit insurance assessments as average consolidated total assets minus average tangible equity. As Congress intended, the change in the assessment base shifted some of the overall assessment burden from community banks to the largest institutions, which rely less on domestic deposits for their funding than do smaller institutions. The result was a sharing of the assessment burden that better reflects each group's share of industry assets. Aggregate premiums paid by institutions with less than \$10 billion in assets declined by approximately one-third in the second quarter of 2011, primarily due to the assessment base change.

In the aftermath of the financial crisis and recession, as well as the enactment of the Dodd-Frank Act, many community banks had concerns about their continued viability in the U.S. financial system. Prompted by that concern, the FDIC initiated a comprehensive review of the U.S. community banking sector covering 27 years of data and released the *FDIC Community Banking Study* in December 2012.

Our research confirms the crucial role that community banks play in the U.S. financial system. As defined by the Study, community banks represented 95 percent of all U.S. banking organizations in 2011. These institutions accounted for just 14 percent of the U.S. banking assets, but held 46 percent of all the small loans to busi-

nesses and farms made by FDIC-insured institutions. While their share of total deposits has declined over time, community banks still hold the majority of bank deposits in rural and micropolitan counties.² The Study showed that in 629 U.S. counties (or almost one-fifth of all U.S. counties), the only banking offices operated by FDIC-insured institutions at year-end 2011 were those operated by community banks. Without community banks, many rural areas, small towns and urban neighborhoods would have little or no physical access to mainstream banking services.

The Study found that community banks that grew prudently and that maintained diversified portfolios or otherwise stuck to their core lending competencies funded by stable core deposits during the Study period exhibited relatively strong and stable performance over time. Institutions that departed from the traditional community bank business model generally underperformed over the long run. These institutions pursued higher-growth strategies—frequently through commercial real estate or construction and development lending—financed by volatile funding sources. This group encountered severe problems during real estate downturns and characterized the community banks that failed during the aftermath of the crisis.

As the primary Federal regulator for the majority of smaller institutions (those with less than \$1 billion in total assets), the FDIC is keenly aware of the challenges facing community banks. The FDIC has tailored its supervisory approach to consider the size, complexity, and risk profile of the institutions it oversees. For example, large institutions (those with \$10 billion or more in total assets) are generally subject to continuous supervision (targeted reviews throughout the year), while smaller banks are examined periodically (every 12 to 18 months) based on their size and condition. Additionally, the frequency of our examinations of compliance with the Community Reinvestment Act can be extended for smaller, well-managed institutions. Moreover, in Financial Institution Letters issued to the industry to explain regulations and guidance, the FDIC includes a Statement of Applicability to institutions with less than \$1 billion in total assets.

In addition to the changes in the Dodd-Frank Act affecting community banks, the FDIC also reviewed its examination, rulemaking, and guidance processes during 2012 as part of our broader review of community banking challenges, with a goal of identifying ways to make the supervisory process more efficient, consistent, and transparent, while maintaining safe and sound banking practices. Based on the review, the FDIC has implemented a number of enhancements to our supervisory and rule-making processes. First, the FDIC has restructured the pre-exam process to better scope examinations, define expectations, and improve efficiency. Second, the FDIC is taking steps to improve communication with banks under our supervision through the use of Web-based tools, regional meetings and outreach. Finally, the FDIC has instituted a number of outreach and technical assistance efforts, including increased direct communication between examinations, increased opportunities to attend training workshops and symposiums, and conference calls and training videos on complex topics of interest to community bankers. The FDIC plans to continue its review of examination and rule-making processes, and continues to explore new initiatives to provide technical assistance to community banks.

Conclusion

Thank you for the opportunity to share with the Committee the work that the FDIC has been doing to address systemic risk in the aftermath of the financial crisis. I would be glad to respond to your questions.

²The 3,238 U.S. counties in 2010 included 694 micropolitan counties centered on an urban core with populations between 10,000 and 50,000 people, and 1,376 rural counties with populations less than 10,000 people.

Status of FDIC Dodd-Frank Act Rulemakings

Completed FDIC-only Rulemakings

FDIC has met all applicable deadlines in issuing those required regulations in the Dodd-Frank Wall Street Reform and Consumer Protection Act for which it is solely responsible. These include:

- Orderly Liquidation Authority (OLA) Regulations
 - Inflation adjustment for wage claims against financial company in receivership;
 - Executive compensation clawbacks and definition of compensation; and
 - Definition of ‘predominantly engaged in activities financial in nature’ for title II purposes.
- Deposit Insurance Fund Management Regulations
 - Regulations establishing an asset-based assessment base;
 - Regulations implementing permanent \$250,000 coverage;
 - Elimination of pro-cyclical assessments; dividend regulations;
 - Restoration plan to increase the minimum reserve ratio from 1.15 to 1.35% by Sept. 30, 2020; and
 - Regulations implementing temporary full Deposit Insurance coverage for non-interest bearing transaction accounts (Program expired 12/31/12).

The FDIC has also issued several optional rules, including the following OLA rules:

- Rules governing payment of post-insolvency interest to creditors;
- Rules establishing the proper measure of actual, direct, compensatory damages caused by repudiation of contingent claims;
- Rules governing the priority of creditors and the treatment of secured creditors;
- Rules governing the administrative claims process;
- Rules governing the treatment of mutual insurance holding companies; and
- Rules providing for enforcement of contracts of subsidiaries or affiliates of a covered financial company.

Completed Interagency Rules:

FDIC and its fellow agencies have issued a number of joint or interagency regulations. These include:

- Title I resolution plan requirements;
- Regulations implementing self-administered stress tests for financial companies;
- Minimum leverage capital requirements for IDIs (Collins §171(b)(1));
- Minimum risk-based capital requirements (Collins §171(b)(2));
- Capital requirements for activities that pose risks to the financial system (Collins §171(b)(7)) (as of July 9, 2013);
- Rules providing for calculation of the “maximum obligation limitation”;
- Regulations on foreign currency futures;
- Removing regulatory references to credit ratings;
- Property appraisal requirements for higher cost mortgages; and
- Appraisal independence requirements.

Rulemakings in process—FDIC-only:

A few regulations without statutory deadlines remain in process. These include:

- OLA regulations implementing post-appointment requirements and establishing eligibility requirements for asset purchasers.

Interagency Rulemakings in process:

- Additional OLA Rules:
 - Orderly liquidation of covered brokers and dealers;
 - Regulations regarding treatment of officers and directors of companies resolved under Title II; and
 - QFC recordkeeping rules;
- Regulations implementing the credit exposure reporting requirement for large BHCs and nonbank financial companies supervised by the FRB;
- Regulations implementing the “source of strength” requirement for BHCs, S&LHCs, and other companies that control IDIs;
- Capital and margin requirements for derivatives that are not cleared OTC;
- The Volcker Rule prohibiting proprietary trading and acquisition of interest in hedge or private equity funds by an IDI or company that controls an IDI or affiliates;
- Regulations governing credit risk retention in asset-backed securitizations, including ABS backed by residential mortgages;
- Regulations governing enhanced compensation structure reporting and prohibiting inappropriate incentive-based payment arrangements;
- Rulemaking prohibiting retaliation against an IDI or other covered person that institutes an appeal of conflicting supervisory determinations by the CFPB and the appropriate prudential regulator; and
- Additional appraisals and related regulations:
 - Minimum requirements for registration of appraisal management companies and for the reporting of the activities of appraisal management companies to Appraisal Subcommittee;
 - Regulations to implement quality controls standards for automated valuation models; and
 - Regulations providing for appropriate appraisal review.

PREPARED STATEMENT OF THOMAS J. CURRY

COMPTROLLER OF THE CURRENCY, OFFICE OF THE COMPTROLLER OF THE CURRENCY

JULY 11, 2013

Chairman Johnson, Ranking Member Crapo, and Members of the Committee, thank you for the opportunity to discuss those provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or Act) that reduce systemic risk and improve financial stability.* The global financial crisis was unprecedented in its severity and exposed a number of fundamental weaknesses in the regulation of the financial system. In response, Congress passed the Dodd-Frank Act, which contains the most comprehensive reforms to the financial system since the Great Depression. These reforms address systemic issues that contributed to the crisis, strengthen the oversight, regulation, and resolution provisions applicable to large financial institutions, and promote greater market stability by, among other things, increasing the transparency and oversight of swaps and other derivatives activities, and mandating that the largest bank holding companies and systemically significant nonbank companies prepare resolution plans demonstrating how they can be resolved in a bankruptcy proceeding. The Act requires Federal regulators to put in place new buffers and safeguards to protect against future financial crises, such as requiring enhanced prudential capital and liquidity standards for large, complex banks, and provides Federal regulators with a number of new tools to help avoid future problems. While many of the rules to implement these reforms are still being developed, once in place they will serve to reduce systemic risk and add to the resiliency of the largest financial institutions and, ultimately, our economy.

As economic conditions have improved, so has the condition of the institutions the Office of the Comptroller of the Currency (OCC) supervises. These institutions have made significant progress in repairing their balance sheets with stronger capital, improved liquidity, and timely recognition and resolution of problem loans. For national banks and Federal savings associations, tier 1 common equity is at 12.3 percent of risk-weighted assets, up from its low of just over 9 percent at the end of 2008.¹ The current capital leverage ratio is now about 9 percent, which is up almost a third from its recent low. Reliance on volatile funding sources has dropped from its fall 2006 peak of 46 percent of total liabilities to 22 percent today. Asset quality indicators are improving with charge-off rates declining for all major loan categories. Indeed, for all but residential mortgages, charge-off rates have now dropped below their post-1990 averages.

While these are positive developments, there remains much to do, and we are continuing to stress that institutions must stay vigilant about monitoring new and existing risk. This is certainly not the time to dispense with this renewed focus on risk management and, as I discuss in my testimony, the OCC is actively raising the bar on our supervisory expectations for the largest banks we oversee.

In response to the Committee's letter of invitation, my testimony will cover actions we have taken to improve financial stability through enhanced prudential regulation and supervision, to finalize those rules for which the OCC has independent rule writing authority, and to strengthen risk-based capital, liquidity, and leverage. I will also address developments regarding the provisions of Title VII of the Act, our work with other Federal banking agencies regarding the resolution of any failing systemically important financial institution under Title II, and the Volcker Rule. Finally, I will conclude with a discussion of how the Act has affected the OCC's regulation of the many community banks and thrifts we supervise and an update on the status of certain interagency Dodd-Frank Act regulations.

I. Improving Financial Stability Through Enhanced Prudential Regulation and Supervision

As I have noted in previous testimony,² large banks are critical to the proper functioning of the capital markets and to a vital economy and thus need to be regulated and supervised more rigorously than less systemically important banks. In applying the lessons we learned from the financial crisis, the OCC is focusing on improving its supervisory program and has increased expectations for the largest banks. In addition, the OCC has increased collaboration and coordination with both domestic and international regulators in order to leverage our collective resources and supervise our institutions more efficiently and effectively. The OCC has also

*Statement required by 12 U.S.C. §250: The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

¹ Performance and financial data are based on March 31, 2013, Call Report information.

² <http://www.occ.treas.gov/news-issuances/congressional-testimony/2012/pub-test-2012-86-written.pdf>

worked diligently to complete all rulemakings required by the Act both where the OCC has authority to issue rules independently and in collaboration with the other regulators on interagency rules. We believe that these actions will result in a stronger and safer banking system.

A. Improving Supervision

Examiner Oversight

The financial crisis underscored the importance of bank supervision and the role of examiner judgment, along with strong regulation and robust analytics, as cornerstones of a healthy financial system. While laws and regulations take a long view and cannot be easily tailored to new developments, our examiners pay close attention to changes in the financial environment generally and changes in individual risk profiles specifically. This proactive approach helps to identify and correct emerging issues before they become major problems. Our examiners are seasoned professionals who bring the benefit of sound judgment and years of experience to their work. This work demonstrates the importance of having examiners’ “boots on the ground” to better communicate our expectations and to ensure that these expectations are met.

Heightened Expectations

Higher supervisory expectations for the large banks we oversee, together with bank management’s implementation of these expectations, are consistent with the broad goal of the Dodd-Frank Act to strengthen the financial system. We believe that this increased focus on strong corporate governance and risk management will both help to maintain the balance sheet improvements achieved since the financial crisis and make these institutions better able to withstand the impact of future crises. For example, as part of this increased focus, we have communicated our expectations for independent directors to present a credible challenge to bank management and to have a thorough understanding of the bank’s risks. Informed directors can better question the propriety of strategic initiatives and assess the balance between risk-taking and reward. We also expect these banks to have strong audit and risk management functions, and we directed bank audit and risk management committees to perform gap analyses relative to the OCC’s standards and industry practices and to close the identified gaps. While more work is required, I am pleased to say that progress is being made in closing identified gaps.

Our views on heightened expectations for strong corporate governance and risk management also extend to the way banks define and communicate risk tolerance expectations across the company. For example, our examiners are directing banks to complement existing risk tolerance structures with measures that address the amount of capital or earnings that may be at risk on a firm-wide basis, the amount of risk that may be taken in each line of business, and the amount of risk that may be taken in each of the key risk categories monitored by the banks.

The OCC is reinforcing these heightened expectations through our ongoing supervisory activities and frequent communication with bank management and boards of directors. Examiners prepare and discuss with bank management a quarterly analysis of each large bank’s progress toward meeting the OCC’s heightened expectations. In addition, each bank’s Report of Examination now includes an overall rating of how the bank is meeting these heightened expectations.

Another OCC initiative that complements our views on heightened expectations is the idea of legal entity structure simplification. The OCC is working with the large banks we oversee to reduce the number and complexity of legal entities within their organizations and to ensure that remaining legal entities are properly aligned with the banks’ key lines of business. While we understand that banks may need time and will likely incur some expense in undertaking such restructuring, we believe it will greatly improve transparency, resolvability, risk management, and governance at the largest banks we supervise.

Risk Identification

The OCC’s National Risk Committee (NRC) contributes to our supervisory responsibilities by monitoring the condition of the Federal banking system as a whole as well as emerging threats to the system’s safety and soundness. The NRC also monitors evolving business practices and financial market issues and helps to shape our supervisory efforts to address emerging risk issues. NRC members include senior agency officials who supervise banks of all sizes, as well as officials from the legal, policy, and economics departments. The NRC helps to formulate the OCC’s annual bank supervision operating plan that guides our supervisory strategies for the coming year. The NRC also publishes the *Semiannual Risk Perspective* report to provide information to the industry and to the general public on issues that may pose

threats to the safety and soundness of OCC-regulated financial institutions. This report is part of our effort to make our supervision priorities more transparent to the boards and management of national banks and Federal savings associations. We believe the institutions we supervise can better calibrate their own risk management strategies by understanding the OCC's supervisory strategies and the emerging risks the agency is focused on. The most recent report, published in June of this year, presents data on the operating environment, the condition and performance of the banking system, and trends in funding, liquidity, interest rate risk, and regulatory actions.³

B. Domestic Collaboration and International Coordination

Domestic Collaboration

While the OCC has always sought to coordinate our supervisory efforts with other Federal banking agencies, the Dodd-Frank Act has made interagency collaboration even more critical. This collaboration allows the agencies to contribute their unique expertise and to reduce unnecessary duplication.

Therefore, we have increased our efforts to work with the other Federal banking agencies and recently implemented a number of guiding principles for interagency coordination with the Board of Governors of the Federal Reserve System (FRB) and the Federal Deposit Insurance Corporation (FDIC). Thus, for the largest national banks and thrifts, examiners are more closely coordinating with the FRB and FDIC to develop supervisory strategies that will promote more efficient and effective allocation of resources to key priorities and risks, while reducing redundant or duplicative supervisory activities. We have also invited our prudential regulatory partners to attend meetings of the OCC's NRC to share more promptly information about risks.

The OCC and the other Federal banking agencies also have entered into a memorandum of understanding (MOU) with the Bureau of Consumer Financial Protection (CFPB) that clarifies how the agencies will coordinate their supervisory activities consistent with the Act. The objective of the MOU is to minimize unnecessary regulatory burden, avoid duplication of effort, and decrease the risk of conflicting supervisory directives. The MOU specifically addresses cooperation on scheduling examinations and other supervisory activities as well as information sharing.

International Coordination

The OCC has also been working internationally to coordinate supervisory efforts following the financial crisis and the passage of the Dodd-Frank Act. The international Basel III agreements incorporated many of the lessons relating to bank capital that the global community learned from the financial crisis. As members of the Basel Committee on Bank Supervision (Basel Committee), the Federal banking agencies had a critical role in the development of these enhanced capital standards, and the final rule that I approved on July 9th and that is described more fully in my testimony reflects many of those key provisions.

The OCC also has taken a leading role in international discussions relating to cross-border resolutions. The OCC is a member of the Basel Committee's Cross-Border Bank Resolutions Group and participates in the Financial Stability Board's Cross-Border Crisis Management Group. In addition, the OCC participates in firm-specific Crisis Management Groups and Supervisory Colleges and is engaged with the other U.S. banking agencies in developing Cooperation Agreements with foreign jurisdictions that will allow for information sharing and coordination in future crises affecting large, cross-border financial institutions.

The OCC is also playing a leading role internationally in improving supervisory practices and principles and overseeing the timely, consistent, and effective implementation of Basel Committee standards around the world.

C. Dodd-Frank OCC Rulemakings

In response to the Committee's request to discuss the status of the rules required by the Dodd-Frank Act, I am pleased to report that all of the rules that the OCC has authority to issue independently have been completed. This includes rules relating to lending limits (section 610), stress testing (section 165(i)(2)), the removal of references to credit ratings (section 939A), and retail foreign exchange transactions (section 742). A summary of each of these rules follows.

³ <http://el.occ/publications/publications-by-type/other-publications-reports/semiannual-risk-perspective/semiannual-risk-perspective-spring-2013.pdf>

Lending Limits

The Dodd-Frank Act directly addressed concentrations of credit by requiring banks to account for derivatives and securities financing transactions under the lending limit rules. Both of these categories of instruments contributed to systemic risk during the crisis, in part, due to lack of transparency around exposures. Under the National Bank Act, the total loans and extensions of credit by a national bank to a person outstanding at one time may not exceed 15 percent of the unimpaired capital and unimpaired surplus of the bank if the loan is not fully secured, plus an additional 10 percent of unimpaired capital and unimpaired surplus if the loan is fully secured. Section 610 of the Dodd-Frank Act amended the definition of “loans and extensions of credit” to include any credit exposure to a person arising from a derivative transaction, or a repurchase agreement, reverse repurchase agreement, securities lending transaction, or securities borrowing transaction (collectively, securities financing transactions), between a national bank and that person.

The OCC published a final rule on June 25, 2013. The final rule provides significant flexibility for meeting these new requirements, particularly for smaller-sized institutions, by offering national banks and savings associations three methods for calculating the credit exposure of most derivative transactions, a special rule for measuring the exposure of credit derivatives, and three methods for calculating such exposure for securities financing transactions. These methods vary in complexity and permit institutions to adopt compliance alternatives that fit their size and risk management requirements, consistent with safety and soundness and the goals of the statute. To permit institutions the time necessary to conform their operations to the amendments implementing section 610, the OCC has extended the temporary exception period for the application of these new lending limit rules through October 1, 2013.

Stress Testing

The use of stress tests during the financial crisis played a critical role in restoring confidence in the U.S. banking system, and Congress codified further use of stress testing as a regulatory tool through several provisions of the Dodd-Frank Act. On October 9, 2012, the OCC published a final rule that implements section 165(i) of the Dodd-Frank Act, which requires national banks and Federal savings associations with total consolidated assets over \$10 billion to conduct annual stress tests pursuant to regulations prescribed by their respective primary financial regulator.

The final rule defines “stress test”, establishes methods for the conduct of the company-run stress test that must include at least three different scenarios (baseline, adverse, and severely adverse), establishes the form and content of reporting, and compels covered institutions to publish a summary of the results of the stress tests. The requirements for these company-run stress tests are separate and distinct from the supervisory stress tests, also required under section 165(i), that are conducted by the FRB. Nevertheless, we believe these efforts are complementary, and we are committed to working closely with the FRB and the FDIC to coordinate the timing of, and the scenarios for, these tests.

On November 15, 2012, the OCC and other regulators released the stress scenarios for the company-run stress tests covering baseline, adverse, and severely adverse conditions. Covered institutions with more than \$50 billion in assets conducted their first stress tests under the rule and reported and disclosed the results. The OCC is reviewing the results as part of its ongoing supervision of these institutions.

Removal of References to Credit Ratings From OCC Regulations

On June 13, 2012, the OCC published a final rule to implement section 939A of the Dodd-Frank Act by removing references to credit ratings from the OCC’s non-capital regulations, including the OCC’s investment securities regulation, which sets forth the types of investment securities that national banks and Federal savings associations may purchase, sell, deal in, underwrite, and hold. These revisions became effective on January 1, 2013.

Under prior OCC rules, permissible investment securities generally included Treasury securities, agency securities, municipal bonds, and other securities rated “investment grade” by nationally recognized statistical rating organizations such as Moody’s, S&P, or Fitch Ratings. The OCC’s final rule revised the definition of “investment grade” to remove the reference to credit ratings and replaced it with a new non-ratings-based creditworthiness standard. To determine that a security is “investment grade” under the new standard, a bank must perform due diligence necessary to establish: (1) that the risk of default by the obligor is low; and (2) that full and timely repayment of principal and interest is expected. Generally, securities with good to very strong credit quality will meet this standard.

The OCC recognized that some national banks and Federal savings associations needed time to make the adjustments necessary to make “investment grade” determinations under the new standard. Therefore, the OCC allowed institutions nearly 6 months to come into compliance with the final rule.

To aid this adjustment process, the OCC also published guidance to assist institutions in interpreting the new standard and to clarify the steps they can take to demonstrate that they meet their diligence requirements when purchasing investment securities and conducting ongoing reviews of their investment portfolios.

Retail Foreign Exchange Transactions

On July 14, 2011, the OCC published its final retail foreign exchange transactions rule (Retail Forex Rule) for national banks and Federal branches and agencies of foreign banks. The Retail Forex Rule imposes a variety of consumer protections—including margin requirements, required disclosures, and business conduct standards—on foreign exchange options, futures, and futures-like transactions with retail customers (persons that are not eligible contract participants under the Commodity Exchange Act). To promote regulatory comparability, the OCC worked closely with the Commodity Futures Trading Commission (CFTC), Securities Exchange Commission (SEC), FDIC, and FRB in developing the Retail Forex Rule and modeled the Retail Forex Rule on the CFTC’s rule.

After the transfer of regulatory authority from the Office of Thrift Supervision, the OCC updated its Retail Forex Rule to apply to Federal savings associations. This interim final rule with request for comments was published on September 12, 2011. The OCC also proposed last October to update its Retail Forex Rule to incorporate the CFTC’s and SEC’s recent further definition of “eligible contract participant” and related guidance. The OCC is currently working to finalize that proposal.

II. Strengthening Capital and Liquidity

A. Comprehensive Revisions to Capital Rules

Earlier this week, the OCC joined the other Federal banking agencies in issuing comprehensive revisions to the capital rules that incorporate changes to the international capital framework published by the Basel Committee as well as certain elements of the Dodd-Frank Act (domestic capital rules) that we believe will strengthen our Nation’s financial system by reducing systemic risk and improving the safe and sound operation of the banks we regulate. Strong capital standards are critical to moderate economic downturns and position the banking system to serve as a catalyst for recovery by ensuring that financial institutions stand ready to lend throughout the economic cycle.

The recent financial crisis was marked by significant concerns about the riskiness of assets and the ability of bank capital to absorb losses. Internationally, the OCC was part of the effort to strengthen standards that produced Basel III. The domestic capital rules constitute a parallel effort to address the same broad concerns about capital and risk. A number of the changes adopted in the domestic capital rules complement the capital provisions in the Dodd-Frank Act. Importantly, the agencies have calibrated the new standards to reflect the nature and complexity of the different institutions they regulate. Therefore, although some requirements apply to all national banks and Federal savings associations, many requirements will apply only to the largest banking organizations that engage in complex or risky activities.

Some of the more significant revisions in the domestic capital rules include increasing both the quantity and the quality of capital necessary to meet minimum regulatory requirements, enhancing the minimum leverage ratio requirements for the largest banks, incorporating incentives to clear more derivatives transactions through regulated central counterparties, and adding stress assessments into many of the risk-based capital requirements. Additionally, the agencies issued a proposal that would further increase the leverage ratio requirements applicable to the largest, most complex banking organizations.

Increased Quantity and Improved Quality of Required Capital

The domestic capital rules increase the quantity and improve the quality of the capital that national banks and Federal savings associations must hold to meet their regulatory requirements. The rule does this by narrowing the definition of regulatory capital and raising the overall minimum required levels of capital. The rule also establishes a new capital measure called Common Equity Tier 1 (CET1). This measure includes only the forms of capital that proved to be the most reliably loss absorbing during the financial crisis and subsequent economic downturn. The domestic capital rules require national banks and Federal savings associations to have CET1 capital equal to at least 4.5 percent of their risk-weighted assets.

In addition to the regulatory minimums, the domestic capital rules apply a capital conservation buffer requirement to all national banks and Federal savings associations and a countercyclical capital buffer requirement to banking organizations subject to the advanced approaches rules (i.e., those with assets in excess of \$250 billion or foreign exposures of more than \$10 billion).

The capital conservation buffer consists of an additional amount of CET1 capital equal to 2.5 percent of a national bank's or Federal savings association's risk-weighted assets.⁴ A banking organization that fails to hold enough CET1 capital to satisfy the buffer requirement will face restrictions on its ability to issue and pay dividends and to make discretionary bonus payments. During the recent financial crisis and economic downturn, some banking organizations continued to pay dividends and substantial discretionary bonuses even as their financial condition weakened; the capital conservation buffer will limit such practices and force banking organizations to conserve capital for periods of economic distress.

The countercyclical capital buffer can be activated in an expansionary credit cycle to increase regulatory capital requirements during periods of rapid growth. The goal of this requirement is to reduce excesses in lending and to protect against the effects of weakened underwriting standards. The countercyclical capital buffer would increase the capital conservation buffer for advanced approaches banking organizations by as much as another 2.5 percent of their risk-weighted assets.

A separate surcharge on systemically important banks (the so-called SIFI surcharge), which is to be the subject of a separate rulemaking, would add another 1 percent to 2.5 percent of risk-weighted assets to the risk-based capital requirements of the largest banks. The cumulative effect of the countercyclical buffer and the potential SIFI requirement is that during an upswing in the credit cycle, some large U.S. banks may be required to hold CET1 equal to as much as 12 percent of their risk-weighted assets, and this level could rise further should the systemic footprint of these banks increase.

Leverage Ratio Capital Requirements

Under the domestic capital rules, all banking organizations must meet a minimum leverage ratio requirement designed to constrain the build-up of leverage and reinforce the risk-based requirements with a non-risk-based backstop.

To be considered "adequately capitalized" from a leverage ratio perspective, all national banks and Federal savings associations must have tier 1 capital equal to at least 4 percent of their total on-balance sheet assets. The minimum ratio for a bank to be "well capitalized" is 5 percent. Applying both risk-based capital requirements and leverage capital requirements is appropriate because the two different standards work together to offset potential weaknesses and reduce incentives for regulatory capital arbitrage.

For national banks and Federal savings associations subject to the advanced approaches rules, the domestic capital rules add a "supplemental leverage ratio" requirement. The supplemental leverage ratio requirement provides that an advanced approaches bank may not be considered "adequately capitalized" unless it has tier 1 capital equal to at least 3 percent of its leverage exposure, which is equal to the bank's on-balance sheet assets plus a credit equivalent amount that represents the bank's off-balance sheet exposures. Because large banking organizations often have large off-balance sheet exposures through different kinds of lending commitments, derivatives, and other activities, the 3-percent supplemental leverage ratio requirement is expected to be a more demanding standard than the current 4-percent leverage ratio requirement.

The OCC, together with the FRB and FDIC, just issued a proposal that would substantially increase the minimum supplemental leverage ratio requirement applicable to the largest and most complex banking organizations.⁵ Under the new supplemental leverage ratio proposal, the largest and most systemically important banks would be required to maintain an even higher ratio of tier 1 capital to leverage exposure in order to be deemed "well capitalized." A higher supplemental leverage requirement for such institutions would place additional private capital at risk before calling upon the Federal deposit insurance fund or the Federal Government's resolution mechanisms. The OCC expects that this higher requirement would become the de facto minimum if finalized as proposed because large banking organiza-

⁴Therefore, to meet both the regulatory minimum, plus the capital conservation buffer requirement, a bank will have to have CET1 capital equal to or greater than 7 percent of its total risk-weighted assets.

⁵The proposal would apply to any U.S. top-tier bank holding company (BHC) with at least \$700 billion in total consolidated assets or at least \$10 trillion in assets under custody and any insured depository institution subsidiary of such a BHC.

tions generally engage in activities that are permitted only for institutions that are well capitalized.

The OCC will carefully consider comments received on this proposal from all stakeholders.

Incentives To Clear Derivatives Through Central Counterparties

While the domestic capital rules include a number of changes to the way banks calculate risk-weighted assets that will improve the risk-sensitivity of the rules, among the more important provisions from a systemic perspective are new requirements that provide strong incentives for banks to clear derivatives through regulated central counterparties. Under the domestic capital rules, when a national bank or Federal savings association clears a derivatives transaction through a qualifying central counterparty, the risk-based capital requirement applied to the exposure will be substantially lower than the requirement that otherwise would apply had the transaction not been cleared through the central counterparty.

Clearing more transactions through regulated central counterparties will help improve the safety and soundness of the derivatives market through greater netting of exposures, the establishment and enforcement of collateral requirements, and by encouraging market transparency.

Market Risk Capital Requirements

On August 30, 2012, the OCC published revisions to the market risk capital requirements that apply to national banks engaged in significant trading activities. The revisions to the market risk capital rule substantially increased the overall capital requirements applicable to trading activities, in large part by requiring banking organizations to incorporate stressed economic conditions into their market risk models, adding prudential requirements to improve risk management, and adding disclosure requirements that provide transparency to market participants with regard to the calculation of a bank's market risk capital requirement.

The revised market risk rule also requires the OCC's prior written approval before a banking organization may use a model to calculate its market risk capital requirements. The rule requires a national bank to notify the OCC if it plans to (1) make a change to an approved model that would result in a material change to the bank's risk-weighted assets; (2) extend the use of an approved model to a new business line or product type; or (3) make any material change to its modeling assumptions.

In addition, the U.S. agencies are participating in the Basel Committee's fundamental review of the capital requirements for trading positions. In the second half of 2013, the Committee plans to publish a proposal for comment based on this review. At that point, the U.S. agencies will consider, subject to notice and comment, whether further changes in their market risk capital rules are necessary.

B. Enhanced Liquidity Standards

The maintenance of adequate liquidity is central to the proper functioning of financial markets and the banking sector. During the financial crisis, a number of banks, including some with adequate capital levels, encountered difficulties because they did not appropriately manage their liquidity. The stress on the international banking system resulted in significant Government actions both globally and at home. To address future liquidity shortfalls, the Federal banking agencies and the Basel Committee took some immediate and initial steps to address liquidity risk management.

In 2008, the Basel Committee published detailed guidance (Basel Liquidity Principles) on the risk management and supervision of liquidity risk. In 2010, the Federal banking agencies, the National Credit Union Association, and the Conference of State Bank Supervisors issued an "Interagency Policy Statement on Funding and Liquidity Risk Management" (Liquidity Risk Policy Statement) that incorporates elements of the Basel Liquidity Principles and includes additional liquidity risk management principles previously issued by the agencies. The Liquidity Risk Policy Statement describes the process that institutions should follow to appropriately identify, measure, monitor, and control their funding and liquidity risk. In addition, the Liquidity Risk Policy Statement emphasizes the importance of cash flow projections, diversified funding sources, stress testing, a cushion of liquid assets, and a formal well-developed contingency funding plan as primary tools for measuring and managing liquidity risk.

To complement the Basel Liquidity Principles, in 2010, the Basel Committee issued "Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools" (Basel III Liquidity Framework). The Basel III Liquidity Framework introduces two explicit minimum liquidity ratios—the Liquidity Coverage Ratio and the Net Stable

Funding Ratio—to assist a banking organization in maintaining sufficient liquidity during periods of financial distress.

These ratios are intended to achieve two separate but complementary objectives. The Liquidity Coverage Ratio, with a 30-day time horizon, addresses short-term resilience by ensuring that a banking organization has sufficient high quality liquid resources to offset cash outflows under acute short-term stresses. The Net Stable Funding Ratio seeks to promote longer-term resilience by creating additional incentives for a banking organization to fund its ongoing activities with stable sources of funding. Its goal is to limit over reliance on short-term wholesale funding during times of robust market liquidity and to encourage better assessment of liquidity risk across all on- and off-balance sheet items.

The Basel Committee included a lengthy implementation timeline for both ratios to provide regulators the opportunity to conduct further analysis and to make changes as necessary. The Federal banking agencies are developing a proposed rule to implement the 30-day Liquidity Coverage Ratio in the U.S. for large banking organizations, which we hope to issue for comment by the end of the year.

The Basel III Liquidity Framework's standards, once fully implemented, will complement overall liquidity risk management practices that have been informed and refined by the Liquidity Risk Guidance issued in 2010 and the enhanced liquidity standards proposed by the FRB, in consultation with the OCC, as part of the heightened prudential standards under section 165 of the Dodd-Frank Act.

III. Financial Stability Oversight Council (FSOC)

The Dodd-Frank Act established FSOC with the overarching mission to identify risks to the financial stability of the United States, promote market discipline, and respond to emerging threats to the stability of the U.S. financial system. As a member of FSOC, the OCC regularly interacts with the other financial regulatory agencies to address these types of issues. FSOC enhances the agencies' collective ability to fulfill this critical mission by establishing a formal process for the agencies to exchange information and to probe and discuss the implications of emerging market, industry, and regulatory developments for the stability of the financial system. Through the work of its committees and staff, FSOC also provides a structured framework and metrics for tracking and assessing key trends and potential systemic risks.

Nonbank SIFI Determinations

In section 113 of the Act, Congress gave FSOC the authority to determine that certain nonbank financial companies would be supervised by the FRB and subject to heightened prudential standards, after an assessment as to whether material financial distress at such companies would pose a threat to the financial stability of the United States. In accordance with its 2012 final rule and interpretive guidance, FSOC voted on June 3, 2013, to issue proposed determinations for three nonbank financial companies, and on July 9th, FSOC announced that it made a final determination for two of those companies, General Electric Capital Corporation, Inc. and American International Group, Inc. The third company has requested a hearing. A number of additional provisions apply to designated companies. For example, they would immediately be subject to the FRB's examination authority, enforcement actions under 12 U.S.C. §1818, and assessments by the FRB and the Office of Financial Research. FSOC also is considering additional nonbank financial companies for proposed determinations.

FMU Designations

Title VIII of the Act charges FSOC with the responsibility for identifying and designating systemically important financial market utilities (FMUs). To process payments and settle securities, derivatives, and futures transactions between financial institutions safely and efficiently, our financial system relies on certain established protocols and intermediaries, including FMUs that operate multilateral payment, clearing, or settlement systems among financial institutions.

The Act subjects designated FMUs to heightened supervision by one of three agencies: (1) the SEC in the case of securities clearing agencies; (2) the CFTC in the case of derivatives clearing organizations; and (3) the FRB for all other FMUs (on either a direct or back-up basis). FSOC determines whether to designate an FMU as systemically important on a case-by-case basis, after assessing the FMU's market activities and the effect its failure or disruption would have on critical markets, financial institutions, or the broader financial system. In accordance with a final rule and interpretive guidance issued by the FSOC in July 2011, FSOC des-

ignated eight entities as systemically important FMUs on July 18, 2012.⁶ FSOC also monitors the financial markets and periodically determines whether designation status should remain in place for each FMU or whether it should designate additional FMUs.

Once designated, an FMU is subject to periodic examination by the SEC, CFTC, or FRB, as appropriate. Designated FMUs are also subject to operating rules promulgated by these agencies and must give their supervising agency advance notice of any material changes to their operations. Designated FMUs are subject to enforcement proceedings by their supervising agency for breach of these requirements, for unsafe or unsound practices, or for other violations of law, in accordance with 12 U.S.C. §1818(b).

Other FSOC Authority

In addition to the authority to designate nonbank financial companies and FMUs as systemically important, Congress gave FSOC other tools to address systemic risk. For example, under section 120 of the Act, FSOC has the authority to recommend that the primary financial agencies apply new or heightened standards and safeguards for a financial activity or practice conducted by firms under their respective jurisdictions should FSOC determine that the conduct of such an activity or practice could create or increase the risk of significant liquidity, credit, or other problems spreading among financial institutions, the U.S. financial markets, or low-income, minority, or underserved communities. FSOC exercised this authority on November 13, 2012, with respect to money market mutual funds.

In addition, section 121 of the Act provides that affirmation by two-thirds of FSOC is required in those cases where the FRB determines that a large, systemically important financial institution poses a grave threat to the financial stability of the U.S. such that limitations on the company's ability to merge, offer certain products, or engage in certain activities are warranted, or if those actions are insufficient to mitigate risks, the company should be required to sell or otherwise transfer assets or off-balance sheet items to unaffiliated entities.

IV. Derivatives—Title VII

During the financial crisis, the lack of transparency in derivatives transactions among dealer banks and between dealer banks and their counterparties created uncertainty about whether market participants were significantly exposed to the risk of a default by a swap counterparty. To address this uncertainty, sections 723 and 763 of the Dodd-Frank Act generally require swaps and security-based swaps to be cleared through registered derivatives clearing organizations or clearing agencies (collectively, clearinghouses) and traded on regulated exchanges. Sections 725 and 763 provide the CFTC and SEC enhanced authority over their respective clearinghouses in recognition that by performing centralized activities, clearinghouses concentrate risks and create interdependencies between and among them and their participants.

To further increase transparency and aid financial regulators in monitoring and mitigating systemic risk, sections 728, 729, 763, and 766 establish swap data repositories and require all swaps and security-based swaps to be reported to such repositories.

Pursuant to sections 731 and 763, national banks that are “swap dealers” must register with the CFTC, and those that are “securities-based swap dealers” must register with the SEC. Banks that must register become subject to all of the substantive requirements under Title VII for their swap activities. At this time, eight national banks have provisionally registered as swap dealers. The OCC has provided comments to the CFTC and SEC on rules implementing Title VII when consulted in accordance with Title VII.

Sections 731 and 764 of the Dodd-Frank Act require the OCC, together with the FRB, FDIC, Federal Housing Finance Agency, and Farm Credit Administration, to impose minimum margin requirements on noncleared derivatives for swap dealers and major swap participants that are banks. The OCC, together with these other agencies, published a proposal on May 11, 2011, to establish minimum margin and capital requirements for registered swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants (swap entities) that are subject to agency supervision. To address systemic risk concerns, consistent with

⁶These entities are: The Clearing House Payments Company, L.L.C., on the basis of its role as operator of the Clearing House Interbank Payments System, CLS Bank International, Chicago Mercantile Exchange, Inc., The Depository Trust Company, Fixed Income Clearing Corporation, ICE Clear Credit LLC, National Securities Clearing Corporation, and The Options Clearing Corporation.

the Dodd-Frank Act requirement, the agencies proposed to require swap entities to collect margin for all uncleared transactions with other swap entities and with financial counterparties. However, for low-risk financial counterparties, the agencies proposed that a swap entity would not be required to collect margin as long as its margin exposure to a particular low-risk financial counterparty does not exceed a specific threshold amount of margin. Consistent with the minimal risk that derivatives transactions with commercial end users pose to the safety and soundness of swap entities and the U.S. financial system, the proposal also included a margin threshold approach for these end users, with the swap entity setting a margin threshold for each commercial end user in light of the swap entity's assessment of credit risk of the end user. The proposed margin requirements would apply to new, noncleared swaps or security-based swaps entered into after the proposed rule's effective date.

Given the global nature of major derivatives markets and activities, international harmonization of margin requirements is critical, and we are participating in efforts by the Basel Committee on Bank Supervision (BCBS) and International Organization of Securities Commissions (IOSCO) to address coordinated implementation of margin requirements across G20 Nations. The BCBS-IOSCO working group issued a consultative document in July of 2012, seeking public feedback on a broad policy framework for margin requirements on uncleared swap transactions that would be applied on a coordinated and nonduplicative basis across international regulatory jurisdictions. We and the other U.S. banking agencies and the CFTC re-opened the comment periods on our margin proposals to give interested persons additional time to analyze those proposals in light of the BCBS-IOSCO consultative framework. The banking agencies' comment period closed on November 26, 2012. Many commenters focused on the treatment of commercial end users, urging the agencies to adopt the exemptive approach suggested by the BCBS-IOSCO proposal.

The BCBS-IOSCO working group published a second consultative paper for public comment on February 15, 2013. This paper describes most of the guiding principles for the over-the-counter margin regime envisioned by the BCBS and IOSCO. The comment period closed on March 15th of this year, and the BCBS-IOSCO working group continues its discussions with its parent committees to finalize a regulatory template to guide the participating jurisdictions to a coordinated regulatory structure on uncleared swap margin issues. The OCC and the other agencies continue to monitor these discussions so that U.S. and foreign regulators can coordinate next steps.

Finally, section 716 of the Dodd-Frank Act prohibits the provision of Federal assistance to a national bank swap dealer,⁷ unless the dealer limits its swap activities. Specifically, the swap activities must be limited to (1) hedging and similar risk mitigating activities; and (2) acting as a swaps entity for swaps involving rates or reference assets permissible for investment by a national bank under 12 U.S.C. Section 24 (Seventh). Credit default swaps are not permissible under the second exception unless cleared by a derivatives clearing organization or clearing agency as provided in section 716.

Section 716 also requires the OCC to grant national banks a transition period of up to 24 months to comply with the statute beginning on July 16, 2013. In establishing the appropriate transition period, the statute directs the OCC to consider the potential impact of the bank's divestiture or cessation of "activities that require registration as a swaps entity" on specific statutory factors. "Activities that require registration" include both swap activities covered by the prohibition in section 716 as well as those specifically excluded from the prohibition and thus allowed within the bank.⁸ Further, the statute directs the OCC to consider the impact of divestiture or cessation of those swap activities on mortgage lending, small business lending, job creation, and capital formation versus the potential negative impact on insured depositors and the deposit insurance fund of the FDIC. The OCC also may consider other factors as appropriate.

Consistent with these statutory mandates, the OCC granted seven national banks a 24-month transition period in order to come into conformance with the prohibitions without unduly disrupting lending activities and other functions the statute required us to consider.

Because the framework for derivatives is still being formulated under Title VII, banks that are covered by section 716 have generally not had sufficient clarity to

⁷ In this testimony, "swap dealer" refers to both a securities-based swap dealer regulated by the SEC and a swap dealer regulated by the CFTC.

⁸ Consideration of both covered and excluded swaps, as required by the statute, is appropriate if customers request the transfer of all swaps to a bank affiliate in order to preserve the netting benefits that come from transacting with a single counterparty.

assess how to and where to push out the swaps subject to the prohibition. The prudential regulators, CFTC, and SEC are still issuing proposed rules, final rules, guidance, and exemptive orders to implement Title VII. Although the Title VII regulatory structure is still being implemented, section 716 goes into effect on July 16, 2013. The transition periods will allow banks to develop a transition plan providing for an orderly cessation or divestiture of swaps activities based on a more developed Title VII regulatory framework.

V. Volcker Rule

Section 619 of the Dodd-Frank Act is intended to prohibit certain high-risk proprietary trading and private fund investment activities of banking entities and to limit the systemic risk of such activities. Specifically, section 619 prohibits a banking entity from engaging in proprietary trading and having ownership interests in, or relationships with, a hedge fund or private equity fund, while at the same time permitting certain client-oriented financial services that may technically fall within the statutory prohibitions.

On October 11, 2011, the OCC, FDIC, FRB, and the SEC issued proposed rules implementing the requirements of section 619. The agencies received more than 19,000 comments covering a wide range of perspectives on nearly every aspect of the proposed rule. Overall, commenters urged the agencies to simplify the final rule, to reduce compliance burdens for entities that do not engage in significant trading or covered fund activities, and to address unintended consequences of the proposed rule. Some commenters urged the agencies to adopt a final rule that would set forth fairly prescriptive standards and narrowly construed permitted activity exemptions, as they believed this would minimize potential loopholes and the possibility of evasion. Other commenters urged the agencies to adopt a more flexible, principles-based approach in the final rule, as they believed this would reduce burden and lessen possible unintended consequences.

The OCC, together with the other agencies, continues to devote significant time and resources to developing final rules consistent with the statutory language and with careful consideration to the comments we received including, for example, comments on distinguishing permissible market-making-related activities from prohibited proprietary trading and defining what is a covered fund. To ensure, to the extent possible, that the rules implementing section 619 are comparable and provide for consistent application, the agencies have been regularly consulting with each other and will continue to do so.

The agencies have made significant progress toward developing a final rule that is faithful to the language of section 619 and maximizes bank safety and soundness and financial stability at the least cost to the liquidity of the financial markets, credit availability, and economic growth.

VI. Resolution Authority

The Dodd-Frank Act contains a number of resolution-related provisions that will arm the Federal banking agencies with the information and authority to ensure that planning needed for an organized resolution of the largest and most systemically significant firms is in place.

Living Wills

Section 165 of the Act requires the largest bank holding companies and FSOC-designated nonbank financial companies to prepare a plan for rapid and orderly resolution in the event of material financial distress or failure.⁹ While the statute assigns the oversight of these companies' resolution planning to the FRB and the FDIC, the OCC's experience and expertise as the primary supervisor of the national bank subsidiaries of the largest bank holding companies positions us to make an important contribution to that work. The three agencies are collaborating accordingly. In addition, we expect that the resolution plans, particularly as they are developed and are refined over time, will provide information that is helpful not only to resolution planning but also to our ongoing supervision. An OCC multidisciplinary team is currently developing supervisory strategies with respect to the use of data underlying the resolution plans.

Recovery Planning

In conjunction with resolution planning, some institutions are also preparing recovery plans outlining the steps they would take, as going concerns, to remain via-

⁹A requirement that institutions file resolution plans also had been a recommendation of the Basel Committee's Cross-Border Bank Resolution Working Group, in which the U.S. banking agencies participated. Jurisdictions in addition to the U.S. also are requiring institutions to file such plans.

ble in the case of severe financial pressure. Recovery planning is critical to ensuring the resilience of a firm's core business lines, critical operations, and material entities. Recovery planning as a discipline is integrated with resolution planning, capital and liquidity planning, and other aspects of financial contingency, crisis management, and business continuity planning. The OCC believes that recovery planning must be an integral part of institutions' corporate governance structures and processes, be subject to independent review, and be effectively supported by reporting to the board and its committees. As the primary supervisor for national banks and Federal savings associations, the OCC has an important interest in how recovery planning is carried out. For this reason, the OCC has worked closely with other regulators to provide appropriate informal supervisory guidance for recovery planning, and further coordination is underway.

Orderly Liquidation Authority

In response to the financial crisis, Congress provided to the FDIC in Title II of the Dodd-Frank Act the Orderly Liquidation Authority (OLA). The OLA's provisions are aimed at addressing two policy goals—mitigating the systemic risk that is presented when large financial firms enter the bankruptcy process, and minimizing the moral hazard that arises when investors believe that firms are likely to be granted a Government bail-out to save them from bankruptcy and prevent systemic problems. The OLA provisions aim to address apparent weaknesses inherent in the core features of bankruptcy when resolving systemically important financial institutions while minimizing moral hazard. Thus, Title II gives the FDIC broad discretion in how it funds the resolution process and how it pays out creditors. The FDIC can seek to exercise its discretion in a way that will minimize moral hazard. Title II also changes the way in which qualified financial contracts (QFC) are treated, providing the FDIC with 24 hours to transfer QFCs as compared with the bankruptcy process under which QFCs are not subject to a stay.

VII. Dodd-Frank Impact on Community Banks

The Committee has also requested the OCC to discuss how the Dodd-Frank Act has affected our regulation of community banks and thrifts. The Act is primarily directed toward larger financial institutions, but it does broadly amend some laws in ways that affect the entire banking sector, including community banks and thrifts.

The OCC is sensitive to the necessary differences in supervision between large banks and community banks, and we are taking steps to reduce the burden and expense smaller institutions bear in reviewing and implementing new regulatory requirements.

We believe it is important to assess the potential impact of our regulations on smaller-sized institutions and, where the OCC has rule-making authority under the Dodd-Frank Act, we have tailored our regulations to accommodate concerns of community banks and thrifts. For example, in the recently released lending limits rule, we provided significant additional flexibility for smaller institutions by allowing them to use a simple look-up table to calculate particular exposures. The companion guidance to our rulemaking to remove credit ratings from our investment securities regulations similarly seeks to reduce burden. In implementing these provisions of the Act, our goal has been to meet the objectives of the statute while recognizing the effectiveness of the existing tools and analyses that well-managed community banks and thrifts have routinely used to aid their credit analysis and investment decisions.

We have also reexamined the ways in which we explain and organize our rulemakings to better help community bankers understand the scope and application of the rules to their institutions. For example, the recently released domestic capital rules are accompanied by a 12-page interagency community bank guide and an OCC-issued 2-page pamphlet that helps banks navigate through an otherwise dense and complex rulemaking. The pamphlet is attached as Appendix A hereto. We plan to use this or a variant of this approach in more of our rulemakings to enable community banks and thrifts to more easily determine which provisions apply to them and whether they should comment on proposed rulemakings. Similarly, in October 2012, we provided guidance to clarify that the OCC does not expect community banks to conduct stress tests like those required for larger banks (OCC Bulletin 2012-33). As part of our outreach activities with community bankers, we also regularly welcome input regarding additional ways to improve our communications with community banks and thrifts.

These initiatives are complemented by the efforts of our examiners to serve as a resource to the institutions we supervise. We remain committed to having our examiners work and live in the same communities as the banks they supervise. This al-

lows examiners to develop an in-depth understanding of the local market and to better anticipate and discuss risks with these institutions.

Most recently, the OCC published a new booklet titled *A Common Sense Approach to Community Banking*.¹⁰ The booklet is intended in part to convey our views about the types of practices that make a community bank excel. The booklet reviews topics important to community bankers and highlights those time-tested concepts that all financial institutions should understand and apply to their business.

We also note that under the Dodd-Frank Act, the CFPB has exclusive authority to prescribe regulations administering certain enumerated Federal consumer financial laws. With respect to this rule-making authority, the CFPB is required to consult with the prudential regulators prior to proposing a rule and during the rule-making process “regarding consistency with prudential, market, or systemic objectives” administered by the prudential regulators. This consultation process provides an avenue for the OCC to make the CFPB aware of concerns expressed by all banks, including the community banks and thrifts we supervise. The consultation process has enabled the OCC to have meaningful input in the CFPB’s regulatory process. The OCC has taken this responsibility seriously and has provided comment to the CFPB. For example, the OCC recently submitted a comment letter to the CFPB to express the OCC’s views on the CFPB’s qualified mortgage proposal regarding interpretations on loan originator compensation. The CFPB’s final rule incorporated these suggestions, and we look forward to continuing to provide similar input on issues of concern to our banks and thrifts.

VIII. Update on Status of Dodd-Frank Rulemakings

As discussed earlier, all of the significant rules for which the OCC has independent rule writing authority have been completed. The joint interagency rule on appraisals for higher-priced mortgage loans (section 1471) has also been finalized.

With respect to other rules that require interagency action that are yet to be completed, the OCC is continuing to work cooperatively with our colleagues at other agencies. These rules include those addressing credit risk retention (section 941), the Volcker Rule (section 619), source of strength requirements (section 616(d)), margin and capital requirements for covered swap entities (sections 731 and 764), incentive-based compensation (section 956), automated valuation models used to estimate collateral value (section 1473(q)) and reporting activities of appraisal management companies (section 1473(f)(2)). The OCC has committed the necessary resources to these efforts, and we remain mindful of the need to complete these rules in the near term.

Conclusion

I appreciate the opportunity to appear before this Committee and to update you on the work the OCC has done to address systemic risk concerns at our largest institutions. The Dodd-Frank Act contains a number of tools to address systemic risk, and it is important that we avail ourselves of those tools by completing as quickly as possible the outstanding rules. We believe it is essential to supplement the rules with an equally vigorous approach to supervision. We look forward to keeping the Committee apprised of our progress.

¹⁰ <http://el.occ/publications/publications-by-type/other-publications-reports/common-sense.pdf>

APPENDIX A



New Capital Rule Quick Reference Guide for Community Banks

The new capital rule implements revisions to the risk-based regulatory capital framework for national banks and federal savings associations (collectively, banks). This quick reference tool is a high-level summary of the aspects of the new rule that are generally relevant for smaller, non-complex banks that are not subject to the market risk rule or the advanced approaches capital rule. This quick reference guide does not carry the force and effect of law. The new rule, which can be found on the OCC's Web site along with a Community Bank Guide, sets forth the revised capital standards. Community banking organizations become subject to the new rule on January 1, 2015.

Key Changes From the June 2012 Proposals

Residential Mortgage Exposures: Relative to the existing rules, the risk-based capital treatment of residential mortgage exposures remains unchanged, with available risk weights including 50 percent and 100 percent and a safe harbor from recourse treatment for loans sold with certain repurchase triggers such as early default clauses.

Accumulated Other Comprehensive Income (AOCI) Filter: Banks have a one-time irrevocable option to neutralize certain AOCI components, comparable to the treatment under the prior rules. If banks do not exercise this option, AOCI will be incorporated into common equity tier 1 capital (CET1), including unrealized gains and losses on all available-for-sale securities.

Trust Preferred Securities (TRuPS): Holding companies with assets less than \$15 billion as of December 31, 2009, or organized in mutual form as of May 19, 2010, are allowed to grandfather into tier 1 capital. TRuPS issued before May 19, 2010, are subject to a maximum of 25 percent of tier 1 capital.

Capital Requirements & PCA

The new rule revises Prompt Corrective Action (PCA) capital category thresholds to reflect the new capital ratio requirements and introduces CET1 as a PCA capital category threshold.

PCA Capital Category	Threshold Ratios			
	Total RBC* ratio	Tier 1 RBC* ratio	CET1 RBC* ratio	Tier 1 Leverage ratio
Well capitalized	10%	8%	6.5%	5%
Adequately capitalized	8%	6%	4.5%	4%
Undercapitalized	< 8%	< 6%	< 4.5%	< 4%
Significantly undercapitalized	< 6%	< 4%	< 3%	< 3%
Critically undercapitalized	Tangible Equity/Total Assets ≤ 2%			

*RBC = risk-based capital

Risk-Weighted Assets (RWA)

- The new rule increases risk weights for past-due loans (150 percent risk weight for the portion that is not guaranteed or secured) and high-volatility commercial real estate exposures (150 percent risk weight), and increases credit conversion factors (CCF) for certain short-term loan commitments (20 percent CCF).
- The new rule expands recognition of collateral and guarantors in determining RWAs.
- The new rule removes references to credit ratings.
- For securitization exposures, the new rule establishes due diligence requirements and introduces an approach for assigning regulatory capital that does not rely on external credit ratings.
- Relative to the existing rules, the treatment of corporate and retail loans and U.S. government (and related) entities remains unchanged.

Transition Schedule for New Ratios and Capital Definitions for Community Banks

Year (as of Jan. 1)	2015	2016	2017	2018	2019
Minimum CET1 ratio	4.5%	4.5%	4.5%	4.5%	4.5%
Capital conservation buffer	N/A	0.625%	1.25%	1.875%	2.50%
CET1 plus capital conservation buffer	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of deductions from CET1*	40.0%	60.0%	80.0%	100.0%	100.0%
Minimum tier 1 capital	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum tier 1 capital plus capital conservation buffer	N/A	6.625%	7.25%	7.875%	8.5%
Minimum total capital	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum total capital plus conservation buffer	N/A	8.625%	9.25%	9.875%	10.5%

* Including threshold deduction items that are over the limits.

N/A means not applicable.

Common Equity Tier 1 Capital

The sum of common stock instruments and related surplus net of treasury stock, retained earnings, AOCI, and qualifying minority interests—less applicable regulatory adjustments and deductions that include AOCI (if irrevocable option to neutralize AOCI is exercised).

Mortgage-servicing assets, deferred tax assets, and investments in financial institutions are limited to 15 percent of CET1 and 10 percent of CET1 individually.

Additional Tier 1 Capital

Noncumulative perpetual preferred stock, tier 1 minority interests, grandfathered TRuPS, and Troubled Asset Relief Program instruments—less applicable regulatory adjustments and deductions.

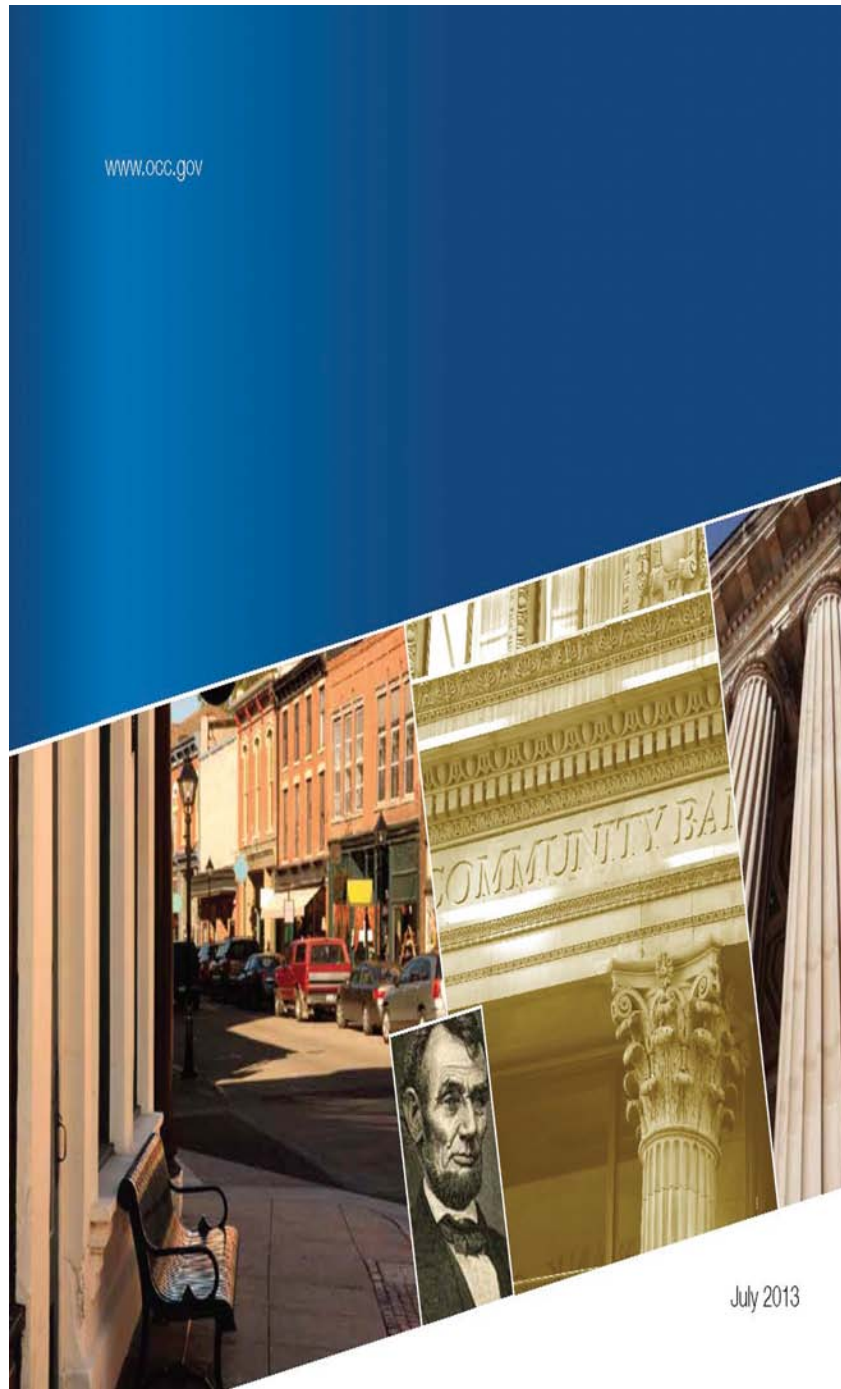
Tier 2 Capital

Subordinated debt and preferred stock, total capital minority interests not included in tier 1, allowance for loan and lease losses not exceeding 1.25 percent of risk-weighted assets—less applicable regulatory adjustments and deductions.

Capital Conservation Buffer

The new rule requires banks to hold CET1 in excess of minimum risk-based capital ratios by at least 2.5 percent to avoid limits on capital distributions and certain discretionary bonus payments to executive officers and similar employees.

Capital Conservation Buffer (as a percentage of RWA)	Maximum Payout Ratio (as a % of the previous four quarters of net income)
Greater than 2.5%	No payout limitation applies
Less than or equal to 2.5% and greater than 1.875%	60%
Less than or equal to 1.875% and greater than 1.25%	40%
Less than or equal to 1.25% and greater than 0.625%	20%
Less than or equal to 0.625%	0%



July 2013

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR CRAPO
FROM MARY J. MILLER**

Q.1. In late 2011, the agencies issued a highly complex and lengthy regulatory proposal to implement the Volcker rule. In February of this year, Chairman Bernanke testified that while regulators have made a lot of progress on the rule, the issues slowing the process “are finding agreement and closure among the different agencies” When can we expect the final rule? What are the reasons for a delay?

A.1. Treasury staff has been actively participating with the Federal banking agencies, the SEC, and the CFTC in an ongoing inter-agency process designed to coordinate development of these rules since January 2011. This process includes regular meetings that serve as constructive forums for the agencies to deliberate on key aspects of the rules. This process resulted in the issuance of proposed regulations that were substantively identical, demonstrating a commitment among the agencies to a coordinated approach, and continues as regulators work to finalize the rules.

Regulators are completing their review of the nearly 18,000 public comments on the proposed rules. Reviewing these comments takes time, and it is important for the rule-making agencies to get the final product right. As the Financial Stability Oversight Council noted in its Volcker Rule study in January 2011, and as the SEC, the CFTC, and the Federal banking agencies noted in their proposed rules to implement the Volcker Rule, the challenge inherent in creating a robust implementation framework is that certain classes of permitted activities—in particular, market making, hedging, underwriting, and other transactions on behalf of customers—often evidence outwardly similar characteristics to prohibited proprietary trading, even as they pursue different objectives. Additionally, effective implementation of the Volcker Rule requires careful attention to differences between types of financial markets and asset classes. We take Treasury’s role as coordinator very seriously and remain committed to working with the rule-making agencies to issue substantively identical final rules.

Q.2. In early June, FSOC voted to designate AIG, Prudential Financial, and GE Capital as nonbank SIFIs, the first three so designated. Some industry observers complained that the process, which took nearly 3 years to complete, lacked transparency. The FSOC did not even announce the names of the firms it had selected; the disclosure came from the firms themselves. How should the FSOC designation process be more open? How are companies that may be considered for nonbank SIFI designation supposed to position themselves vis-a-vis their public disclosures and SEC filings if no formal announcement is made by FSOC?

A.2. The Council voted on June 3, 2013, to make proposed determinations regarding three nonbank financial companies. Each of those companies had been notified in 2012 that it was under review by the Council and had engaged in extensive discussions with staff of the Council members and member agencies. Following the proposed determinations, each of the companies had an opportunity to request a hearing to contest the proposed determination, after which the Council could vote to make a final determination. In ac-

cordance with the Council's interpretive guidance, and due to the preliminary nature of the Council's evaluation of a company prior to a final determination, the Council does not generally intend to publicly announce the name of any nonbank financial company under review before the Council makes a final determination. Any company notified of a proposed or final determination may publicly announce, including in a filing with the SEC, that it is under consideration or has been subject to a final determination by the Council.

The Council voted on July 8, 2013, to make final determinations regarding American International Group, Inc. and General Electric Capital Corporation, Inc. The Council's action was publicly announced the following day, when the Council issued a press release and posted information on its Web site about the determinations along with the basis for each determination. Notification was also provided directly to Congress, in accordance with Section 112(a)(2)(N)(iv) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

The Council recognizes the importance of a careful and transparent process for its determinations, so before engaging in company-specific analyses, it prepared and sought public comment on its proposed analytic framework and process. This public process began in October 2010 with an advance notice of proposed rulemaking, which was followed by two separate notices of proposed rulemaking and ultimately the issuance of a final rule and interpretive guidance in April 2012. The Council's final rule and guidance took into account multiple rounds of comments from stakeholders and the public.

The Council is committed to conducting its work in a manner that is as transparent as possible, while appropriately balancing the need to protect market-sensitive information.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR MENENDEZ FROM MARY J. MILLER

Q.1. Over the last few months, we've seen reports in the press of so-called "regulatory capital trades", in which regulated financial institutions have purchased credit protection (often using credit default swaps) from unregulated entities (often SPVs, hedge funds, or other entities formed offshore to avoid regulation) in order to reduce the amount of capital they need to hold against an investment on their books. In effect, these trades are transferring risk from regulated institutions that are subject to capital requirements to unregulated entities that are not subject to capital requirements, and creating exposure of the regulated institution to a potential default by the unregulated entity.

If this story sounds familiar, it should—this is strikingly similar to what we saw happen with AIG before the financial crisis. These trades are transferring risk from regulated and supervised financial institutions to unregulated corners of the market, where it can build and concentrate without monitoring or supervision by regulators.

The Basel Committee has partly addressed this issue by calling for banks to properly account in their capital calculations for the

costs of credit protection they purchase. But does this proposal do enough to address concerns about regulatory arbitrage and systemic risk accumulating all over again through “shadow banking”? Are you concerned about these “regulatory capital trades”, and what steps are you taking to monitor and address these arrangements?

A.1. These types of transactions constitute one of many types of transactions that may be designed to reduce banks’ regulatory capital without reducing the financial loss exposure that the applicable capital requirements are designed to address. Though it is not a banking regulator, Treasury continues to communicate with the banking regulators and other financial institution regulators to identify and address risks to the financial system that may result from transactions to arbitrage the capital requirements and other prudential standards designed to protect the financial system.

Treasury has been and continues to be a strong advocate for increasing the resilience of the U.S. and international banking systems by significantly increasing the capital held by banks, as well as imposing liquidity standards and other enhanced prudential standards on the largest banks and financial institutions to protect the financial system and the public.

However, the increased capital requirements of Basel III could create incentives for banks to engage in arbitrage transactions to reduce their capital costs by entering into guarantees and other transactions reducing banks’ risk-weighted and leverage assets under the Basel standards. Accordingly, supervisors need to be vigilant to allow such a reduction in a bank’s capital requirements only for qualifying guarantees and other transactions that provide a legitimate reduction in the probability and severity of loss to the bank. Therefore, we agree with the Basel Committee’s reduction of a bank’s capital requirements for qualifying transactions shifting the banks’ risk exposure to a qualifying guarantor or other counterparty. But we also believe that ongoing supervisory scrutiny is needed to ensure that such reductions in capital requirements are only provided when there is an actual transfer of loss exposure to a guarantor or counterparty with the capacity and intent to provide such loss protection to the bank.

As recognized by the Basel Committee, in January 2011, the Federal Reserve issued a supervisory letter on this issue. The banking agencies have supervisory authority over banks and savings associations to scrutinize arbitrage transactions. In addition, the Federal Reserve similarly has broad supervisory authority to deter unsafe and unsound practices by bank holding companies and savings and loan holding companies. Furthermore, under the Dodd-Frank Act, the Financial Stability Oversight Council may designate a nonbank financial company that could pose a threat to U.S. financial stability for Federal Reserve supervision and enhanced prudential standards. The Dodd-Frank Act also tasks the Office of Financial Research with assessing emerging threats to U.S. financial stability. Treasury will continue its communication with the banking and financial regulators with the goal of identifying and addressing arbitrage transactions.

Q.2. I asked you about this topic earlier this year, and I want to ask about it again because it's still important. In New Jersey and across our country, families continue to struggle with high debt burdens, particularly mortgage debt. We're seeing some improvements, but we still have a lot of work left to do. Senator Boxer and I have introduced legislation, the Responsible Homeowner Refinancing Act, that would remove barriers to refinancing for borrowers with GSE mortgages and a history of paying their mortgage on time. This bill would help individual families lower their debt burdens and stay in their homes, and would help the economy as a whole by strengthening demand through consumer deleveraging. Though interest rates have recently started to rise to some degree, many families can still benefit from refinancing. Can you please comment on the importance of continuing our efforts to reduce consumer debt burdens and remove barriers to refinancing mortgages to more affordable levels?

A.2. The Administration continues to support helping all responsible homeowners to have an opportunity to reduce their monthly mortgage payments to more affordable levels by refinancing, particularly by taking advantage of the current low interest rates. As you know, the President has called for broad-based access to refinancing for all borrowers who are current on their payments, including those who are underwater. The Federal Housing Finance Agency (FHFA) recently extended the Home Affordable Refinance Program by 2 years to 2015, and Treasury is working with FHFA to make sure all eligible borrowers can take advantage of this program. An important part of this work is a marketing campaign so more borrowers will become aware of opportunities to refinance.

Q.3. We know that excessive and misaligned compensation schemes provided part of the fuel for the financial crash. In response, I worked to include a provision in Dodd-Frank that would require publicly listed companies to disclose in their annual SEC filings the amount of CEO pay, the amount of the median company worker pay, and the ratio of the two. The SEC, so far, has been slow to implement this measure. Given the importance of providing information to shareholders about executive compensation and better align the incentives of corporate decision makers with shareholder interests, what is Treasury doing, whether through the Financial Stability Oversight Council or otherwise, to help the SEC move forward on this issue?

A.3. We agree that the provision of the Dodd-Frank Act requiring disclosure of CEO pay ratios is a very important component in properly aligning the incentives created by compensation programs with the interests of shareholders going forward. Section 953 of the Dodd-Frank Act gives the SEC sole authority to promulgate a rule on this issue. We encourage the SEC to promptly issue a rule implementing this provision.

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR BROWN
FROM MARY J. MILLER**

Q.1. A critical element of the proposed new Basel leverage ratio is the definition of the denominator (the assets subject to the leverage

requirement). A denominator definition that permits too many bank commitments to remain off the balance sheet and uncapitalized could undermine the benefits of a higher leverage ratio requirement.

Have the banking agencies made a quantitative examination of the change in bank assets subject to the leverage requirement that will be created by the new Basel leverage rules?

Could you please inform us, for the six largest U.S. banks and bank holding companies, the approximate amount of total assets that would be counted for the denominator of leverage capital requirements under the following definitions of assets: U.S. GAAP, IFRS accounting, the proposed Basel leverage ratio definition.

What factors are most important in determining the difference between GAAP and IFRS accounting and the proposed Basel leverage ratio definition? What is the total amount of the difference accounted for by: Changes in off-balance sheet treatment of credit commitments that are not derivatives contracts and changes in derivatives netting and offset rules.

To the degree possible, please include breakdowns of the impact of the relevant sub-changes in each of these areas, as well as written explanations of the areas in the Basel leverage ratio definition that account for the differences.

A.1. Treasury is not a rule-writing agency for bank regulatory capital and has not participated in the development of the banking agencies' new supplementary leverage ratio proposal. Treasury does not have the data necessary to support an analysis as to how particular provisions of the proposal would affect bank assets or how certain types of assets would be affected under different accounting standards. However, Treasury has been and remains supportive of strengthening capital standards. Since the crisis, banking regulators have completed rules to require large, interconnected financial institutions to hold significantly higher levels of capital and liquidity. It is important to recognize that the financial system is significantly stronger than it was 5 years ago. Borrowing is significantly lower, reliance on short-term funding is lower, and liquidity positions have already improved such that large firms are less vulnerable in the event of a downturn. Treasury supports additional efforts by the banking regulators to make the system even stronger.

Q.2. The new leverage ratio proposals mandate a leverage ratio of 6 percent for large bank subsidiaries, but a lower 5-percent ratio for the overall holding company. What policy justification is there for this distinction between the bank and the holding company?

A.2. Treasury is not a rule-writing agency for bank regulatory capital and has not participated in the development of the banking agencies' new supplementary leverage ratio proposal.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR WARREN FROM MARY J. MILLER

Q.1. Has your agency done any studies on the costs and benefits of allowing banks to book derivatives in depositories?

A.1. In general, Treasury has no authority to regulate bank and bank holding company structure or the types of activities that are permitted in different parts of banks or bank holding companies. However, Treasury believes that it is important that depositors are not exposed to the risk of losses from banks due to particularly risky activities. To that end, section 716 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) generally requires a bank holding company to move these activities out of its depository institutions and into separately capitalized affiliates. In addition, section 608 of the Dodd-Frank Act strengthens the restrictions on transactions between a bank and its affiliates within a bank holding company. Section 608 of the Dodd-Frank Act will help reduce the possibility that losses associated with derivatives do not spread to insured depository institutions.

Q.2. A number of derivatives experts, including Frank Partnoy and Satyajit Das, contend that a large percentage of complex OTC derivatives, including credit default swaps, are not used for commerce but for economically unproductive activities such as gaming accounting and tax rules or hiding losses. Have you ever taken a large sample of derivatives transactions to see if these charges have validity? If the charges are accurate, in what ways would you change your views about derivatives regulation?

A.2. Prior to passage of the Dodd-Frank Act, OTC derivatives markets were characterized by opacity. As a result, Treasury worked to include provisions in the Dodd-Frank Act to create transparency in these markets by, for example, requiring the clearing of most derivatives and the reporting of transaction data to regulated swap data repositories (SDRs). Data reported to SDRs are accessible to and can be analyzed by the U.S. regulators with primary jurisdiction over these markets—namely the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC). Moreover, the Dodd-Frank Act provides the CFTC and the SEC with enhanced anti-manipulation and enforcement authority to deter and detect fraud, manipulation, and other abuses in these markets. The CFTC and SEC are working hard to finalize effective rules to implement the requirements of the Dodd-Frank Act and promote the safety, liquidity, and transparency of these markets, as well as to develop systems that allow them to analyze and monitor transactions, positions, risk, and abusive conduct.

Q.3. Members of Congress have been told that the Transatlantic Trade and Investment Partnership negotiations include discussion about “harmonizing” domestic financial regulation among the parties to the TTIP negotiations. Do the negotiations contemplate agreements that would in any way, directly or indirectly, limit prudential or financial stability regulation of the type adopted in the Dodd-Frank Act regardless of how they are described or characterized?

A.3. Financial services are a critical component of the transatlantic relationship. In TTIP, as in all our free trade agreements, the Administration will seek market access commitments for financial services.

Since the financial crisis, Treasury and U.S. financial regulators have been actively engaged on a wide range of financial regulatory

matters domestically and internationally. There is an ongoing robust agenda with ambitious deadlines on international regulatory and prudential cooperation in the financial sector—both bilaterally and under the auspices of the G20 and international standards-setting and other bodies such as the Financial Stability Board, the Basel Committee on Banking Supervision, and the International Organization of Securities Commissions. We expect that work to continue making progress alongside the TTIP negotiation.

Q.4. Has FSOC or the Treasury requested that OFR or Treasury researchers conduct and publish contemporary quantitative estimates of the size and sources of the well-known borrowing cost advantages enjoyed by very large banks? If not, why not?

A.4. The Financial Stability Oversight Council (Council) and Treasury staff have not prepared or requested from the Office of Financial Research estimates of funding costs of very large banks, though staff monitor academic and other research on this topic.

The reforms enacted by the Dodd-Frank Act provide regulators with critical tools and authorities that we lacked before the crisis to resolve large financial firms whose failure would have serious adverse effects on financial stability. The emergency resolution authority for failing firms created under Title II expressly prohibits any bailout by taxpayers. We need to keep making progress implementing the Dodd-Frank Act to make sure that these and the other Dodd-Frank Act reforms are well understood by the public and implemented to reduce risks and strengthen the financial system.

In April 2013, Treasury staff met with representatives from the Government Accountability Office regarding its study focused on potential funding cost advantages of large financial institutions, and we look forward to reading the findings of the GAO's report. Treasury will continue to monitor financial market indicators, such as bank borrowing costs, to understand the impacts of the rules implementing the Dodd-Frank Act, and to understand whether these reforms are effective in creating incentives for the largest, most complex firms to reduce their size and complexity.

Q.5. The FSOC recently designated the first two nonbank Systemically Important Financial Institutions (SIFIs), GE Capital and AIG.

Why did it take so long to designate the first two SIFIs? Do you anticipate that the pace of designation will accelerate in the coming months or years? Why or why not?

As you know, systemic risk can come not only from very large institutions but also come from smaller entities that collectively generate high levels of leverage using the wholesale funding markets. For example, the recent FSOC annual report identified high levels of leverage at mortgage REITs as a risk for market disruption. While no single mortgage REIT may be large enough to be designated as a SIFI under the current rules, collectively the sector can pose risks to financial stability. How does the FSOC plan to address this kind of problem? Would this kind of issue ever call for the designation of a sector, rather than an individual institution, as systemically critical?

A.5. The Council has undertaken a careful and transparent process for its nonbank financial company determinations, including a

process that incorporated multiple rounds of public comments before issuing a final rule and interpretive guidance in April 2012. The Dodd-Frank Act and the Council's rule and interpretive guidance require the Council to engage in extensive company specific analysis to determine whether a company could pose a threat to financial stability and should be subject to supervision by the Federal Reserve and enhanced prudential standards. It is critically important that the Council take the time to get the analysis right, and Council staff have worked diligently to complete each stage of the process. The Council will continue to evaluate nonbank financial companies eligible for Council determinations with the same sense of urgency.

The Dodd-Frank Act provides the Council with various authorities to mitigate threats to financial stability. In addition to the Council's authority to designate nonbank financial companies for supervision by the Federal Reserve and enhanced prudential standards, the Council may also designate systemically important financial market utilities and payment, clearing and settlement activities conducted by financial institutions, which thereby become subject to enhanced risk management standards and supervision. In addition, the Council has authority under section 120 of the Dodd-Frank Act to make recommendations to the primary financial regulatory agencies to apply new or heightened standards for a financial activity or practice that is conducted by bank holding companies or nonbank financial companies under their respective jurisdictions. The Council may employ its section 120 authority, as it did at the end of 2012 in issuing proposed recommendations with respect to money market mutual funds, if it determines that the conduct, scope, nature, size, scale, concentration, or interconnectedness of such activity or practice could create or increase the risk of significant liquidity, credit, or other problems spreading among bank holding companies and nonbank financial companies, financial markets of the United States, or low-income, minority, or underserved communities. In addition, as noted in your question, the Council's most recent annual report—another key tool to highlight potential risks to financial stability—included a discussion of the growth of agency real estate investment trusts and the potential impact of a shock to the sector.

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR CRAPO
FROM DANIEL K. TARULLO**

Q.1. In late 2011, the agencies issued a highly complex and lengthy regulatory proposal to implement the Volcker rule. In February of this year, Chairman Bernanke testified that while regulators have made a lot of progress on the rule, the issues slowing the process “are finding agreement and closure among the different agencies” When can we expect the final rule? What are the reasons for a delay?

A.1. The Federal Reserve, OCC, FDIC, SEC, and CFTC, (the “Agencies”) issued the final regulations implementing section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act on December 10, 2013. As you note, in late 2011, the Agencies issued the proposed rules. The Agencies received over 18,000 com-

ments addressing a wide variety of aspects of the proposals and met with many representatives of the public, including banking firms, trade associations, and consumer advocates, and provide an extended public comment period. The Board and the other rule-making agencies carefully reviewed those comments and suggestions and the issues they raised in light of the statutory provisions in developing the final implementing rules.

Q.2. The *Wall Street Journal* recently reported that certain large U.S. banks presented to the FRB a plan to pay for large banks' restructuring in the event of a future crisis, proposing that each bank hold a combined debt and equity equal to 14 percent of its risk-weighted assets which would be used to prop up any failed bank subsidiary seized by regulators. Is the FRB considering such plan as a viable option? Would that plan work in lieu of, or in addition to, the resolution mechanism in Title II of Dodd-Frank?

A.2. The Federal Reserve supports the progress made by the Federal Deposit Insurance Corporation (FDIC) in implementing Title II of the Dodd-Frank Act, including the proposed single-point-of-entry (SPOE) resolution approach. SPOE is designed to resolve a systemically important company by insuring that the losses are focused on the shareholders and long-term unsecured debt holders of the failed firm. It aims to address the potential system impact of the failure of the firm by providing sufficient capital for critical operating subsidiaries to continue to operate by converting long-term debt holders of the parent into equity holders of the bridge holding company. Key to the ability of the FDIC to execute its SPOE approach under Title II is the availability of sufficient amounts of loss absorbency capacity (e.g., equity and long-term, unsecured debt) at the company. Accordingly, a regulatory requirement that the largest, most complex U.S. banking firms maintain a minimum amount of outstanding long-term unsecured debt on top of their regulatory capital requirements would support the FDIC's implementation of the resolution mechanism under Title II.

Q.3. Recently the FRB finalized its Basel III capital rules. You stated at the Board's public meeting on July 9th that the FRB should be ready in the next few months to issue a notice of proposed rulemaking concerning the combined amount of equity and long-term debt large institutions should maintain in order to facilitate orderly resolution in appropriate circumstances. How much debt the biggest banks would have to issue or how it would be calculated? Would any such proposal give deference to suggestions made by large banks to the FRB that they should hold combined debt and equity equal to 14 percent of risk-weighted assets?

A.3. The Federal Reserve continues to develop, in consultation with the FDIC, a regulatory proposal that would require the most systemic U.S. banking firms to maintain a minimum amount of long-term, unsecured debt (i.e., gone-concern loss absorbency) to supplement existing equity capital requirements (i.e., going concern loss absorbency). Such a proposal should improve the resiliency and market discipline of our most systemic banking firms and contribute to the ability of the FDIC to resolve a firm using its single-point-of-entry approach. Calibration is one of the key issues that the Board is considering as we develop this proposal.

**RESPONSES TO WRITTEN QUESTIONS OF
SENATOR MENENDEZ FROM DANIEL K. TARULLO**

Q.1. Over the last few months, we’ve seen reports in the press of so-called “regulatory capital trades”, in which regulated financial institutions have purchased credit protection (often using credit default swaps) from unregulated entities (often SPVs, hedge funds, or other entities formed offshore to avoid regulation) in order to reduce the amount of capital they need to hold against an investment on their books. In effect, these trades are transferring risk from regulated institutions that are subject to capital requirements to unregulated entities that are not subject to capital requirements, and creating exposure of the regulated institution to a potential default by the unregulated entity.

If this story sounds familiar, it should—this is strikingly similar to what we saw happen with AIG before the financial crisis. These trades are transferring risk from regulated and supervised financial institutions to unregulated corners of the market, where it can build and concentrate without monitoring or supervision by regulators.

The Basel Committee has partly addressed this issue by calling for banks to properly account in their capital calculations for the costs of credit protection they purchase. But does this proposal do enough to address concerns about regulatory arbitrage and systemic risk accumulating all over again through “shadow banking”? Are you concerned about these “regulatory capital trades”, and what steps are you taking to monitor and address these arrangements?

A.1. The Federal Reserve is concerned about and is monitoring the migration of risk from the regulated banking system to the shadow banking system, particularly in light of incentives for such migration that may be created by its ongoing implementation of a significantly stricter regulatory regime for banking organizations. The Federal Reserve also addresses risks posed by derivative and other transactions between banking organizations and unregulated financial entities in a number of ways, including through the recently revised capital rules, its supervisory assessment of capital adequacy, and other supervisory monitoring.

The final rule approved by the Board earlier this year that revised its regulatory capital rules (the final rule) increases the capital requirements for the largest, most complex banking organizations’ exposures to unregulated financial institutions such as hedge funds and financial special purpose vehicles.¹ The Federal Reserve also assesses banking organizations’ overall capital adequacy through the supervisory process. For bank holding companies with total assets of at least \$50 billion, this includes annually reviewing the company’s capital plan, which contains a discussion of how the bank holding company will maintain capital commensurate with its risks under expected and stressful conditions. This analysis incorporates the effectiveness of regulatory capital trades in mitigating a banking organization’s risks under stressful conditions.

In general, the Federal Reserve views a firm’s engagement in risk-reducing transactions as a sound risk management practice.

¹ See, 12 CFR 217.131.

However, the final rule's risk-based capital framework may not fully capture the residual risks that a firm faces with respect to regulatory capital trades.

Thus, when evaluating capital adequacy, including in the context of the Board's annual Comprehensive Capital Analysis and Review, supervisory staff evaluates whether a firm holds sufficient capital in addition to its minimum regulatory capital requirements to cover the risks associated with such transactions. The Federal Reserve further expects a firm that engages in risk transfer transactions to be able to demonstrate that it reflects any potential risks of such transactions in its internal assessment of capital adequacy and that it maintains sufficient capital to address such risks.

In January 2011, the Federal Reserve issued guidance regarding risk transference in Supervision and Regulation Letter 11-1, entitled "Impact of High-Cost Credit Protection Transactions on the Assessment of Capital Adequacy" (SR 11-1).² This guidance emphasized that supervisors would scrutinize transactions with high premiums and fees, but with a questionable degree of risk transference. In particular, the guidance stated that high-cost credit protection transactions would be taken into account in the supervisory assessment of a banking organization's capital adequacy, and in certain cases, the Board may determine that a transaction should not be recognized as a guarantee for risk-based capital purposes. This guidance was issued in response to potential regulatory arbitrage transactions involving little risk transference, and continues to be used in the supervisory evaluation of the capital adequacy of banking organizations. In particular cases, the Board may determine that a transaction should not receive, or only partially receive, favorable risk-based capital treatment based on an assessment of the risks retained by a firm. In addition, as a member of the Basel Committee, the Federal Reserve is participating in the ongoing effort to appropriately address the risks posed by these transactions through international standards.

With respect to monitoring the migration of risk from the regulated banking system to the shadow banking system, in recent years the Federal Reserve has greatly increased the resources it devotes to financial system monitoring. It has also taken a more systematic and intensive approach, led by its Office of Financial Stability Policy and Research and drawing on substantial resources from across the Federal Reserve System. This monitoring informs the policy decisions of the Federal Reserve as well as our work with other agencies. The Federal Reserve also has brought these issues to the attention of the Financial Stability Board (FSB), which currently has five major projects underway focusing on potential systemic risks associated with shadow banking. These include projects considering regulatory initiatives to mitigate the spill-over effect between the regular banking system and the shadow banking system; reduce the susceptibility of money market funds to runs; assess and align the incentives associated with securitization; dampen risks and procyclical incentives associated with securities financing transactions such as repos and securities lending that may exacerbate funding strains in times of market stress; and as-

² See: <http://fedweb.frb.gov/fedweb/bsr/srltrs/sr1101.pdf>.

sess and mitigate systemic risks posed by other shadow banking entities and activities. This past August the FSB issued a policy framework for addressing shadow banking risks in securities lending and repos,³ as well as a policy framework for strengthening the oversight and regulation of shadow banking entities.⁴

The Federal Reserve will continue to monitor shadow banking and risk transfer and will consider further policy actions as necessary to address emerging risks.

Q.2. In New Jersey and across our country, families continue to struggle with high debt burdens, particularly mortgage debt. We're seeing some improvements, but we still have a lot of work left to do. Senator Boxer and I have introduced legislation, the Responsible Homeowner Refinancing Act, that would remove barriers to refinancing for borrowers with GSE mortgages and a history of paying their mortgage on time. This bill would help individual families lower their debt burdens and stay in their homes, and would help the economy as a whole by strengthening demand through consumer deleveraging. Though interest rates have recently started to rise to some degree, many families can still benefit from refinancing. Can you please comment on the importance of continuing our efforts to reduce consumer debt burdens and remove barriers to refinancing mortgages to more affordable levels?

A.2. I share your concern about the effect of high levels of debt and debt payments on household well-being and the economy. Although many homeowners have benefited from the low level of mortgage rates by refinancing their mortgages, other homeowners have been precluded from doing so by tight underwriting standards, negative equity in their homes, a fall in income, or high refinancing fees. The Home Affordable Refinance Program and the National Mortgage Settlement have facilitated refinancing for many of these borrowers. Borrowers who face obstacles to refinancing and are not eligible for these programs, however, continue to struggle.

Mortgage refinancing lowers household debt payments and increases the funds available for other purposes. The decrease in debt payments can help relieve the strains on financially stressed borrowers, and so reduce the probability of default on mortgages or other obligations. Many borrowers may also react to their decrease in debt payments by increasing their spending, thereby probably boosting the economy, on net.

Q.3. I held a hearing earlier this year in the Housing Subcommittee examining the botched independent foreclosure review process and related settlement. At the time, the GAO issued a report that looked at some of the problems that occurred and outlined a set of "lessons learned." In particular, the GAO recommended that the OCC and the Fed improve oversight of sampling and consistency, apply lessons in planning and monitoring to activities under the consent order and continuing reviews, and implement a communication strategy to keep stakeholders informed. I'm concerned, however, by recent reports suggesting that some of the same problems we saw before are continuing to occur. Are you fa-

³ See: http://www.financialstabilityboard.org/publications/r_130829b.pdf.

⁴ See: http://www.financialstabilityboard.org/publications/r_130829c.pdf.

miliar with the GAO's recommendations, and what steps has the Fed taken to implement them? In your own reviews of the process, what other changes have you identified and made?

A.3. On March 26, 2013, the Government Accountability Office (GAO) issued a report titled "FORECLOSURE REVIEW: Lessons Learned Could Enhance Continuing Reviews and Activities Under Amended Consent Orders", (GAO-13-277). This report included three recommendations addressed to the Federal Reserve Board (Board) and the Office of the Comptroller of the Currency (OCC). Consistent with our basic objective of continuous improvement, the Federal Reserve has taken measures to address all of the recommended actions and to improve oversight based on our own experience. Examples of measures we have taken are provided below.

The GAO's first recommendation is for the agencies to improve oversight of sampling methodologies and mechanisms to centrally monitor consistency, such as assessment of the implications of inconsistencies on remediation results for borrowers in the remaining foreclosure reviews. The agreements in principle reached earlier this year between the Board, the OCC, and 15 of the 16 servicers subject to Consent Orders replaced the Independent Foreclosure Review (IFR) requirements of those enforcement actions with a new program of payments to covered borrowers, thereby eliminating the sampling requirement for the 15 firms.⁵ Only one firm, One West Bank, FSB, continues to conduct an IFR. One West Bank, FSB, is regulated by the OCC. With respect to assuring consistency of outcomes, the Federal Reserve and the OCC continue to coordinate closely to ensure that the guidance we provide is consistent.

The GAO's second recommendation is that the agencies identify and apply lessons learned from the foreclosure review process, such as enhancing planning and monitoring activities to achieve goals, as the agencies develop and implement the activities under the amendments to the Consent Orders. The Federal Reserve, in coordination with the OCC, significantly expanded its planning and monitoring efforts during the course of the IFR and continues to devote resources to planning and monitoring the implementation of the remaining requirements of the amendments to the Consent Orders. With respect to the cash payments to borrowers and foreclosure prevention assistance requirements of those amendments in particular, the agencies have taken several steps to enhance their planning and monitoring. Among other things, the agencies have instituted status calls as frequently as daily with the paying agent, Rust Consulting, Inc., to keep the agencies abreast of developments and potential issues with respect to payments to borrowers. The agencies have also worked in close collaboration on a template to be used by all servicers in reporting on their activities to fulfill their foreclosure prevention obligations under the amendments to the Consent Orders. Similarly, the Federal Reserve has devoted re-

⁵Agreements in principle with 13 of the servicers were announced in January 2013. The agreements were memorialized in amendments to the Consent Orders which were published on February 28, 2013. On July 26, 2013, the Board announced a similar amendment to the Board's Consent Order against GMAC Mortgage, and on August 23, 2013, the OCC announced that it reached an agreement in principal with EverBank, which ultimately will be memorialized in an amendment to the OCC's Consent Order against that bank.

sources to advanced planning with respect to public reporting on the IFR where it continues, and on implementation of the remaining amendments to the consent orders.

The GAO's third recommendation is focused on the development of a communication strategy to regularly inform borrowers and the public about the processes, status, and results of the activities under the amendments to the Consent Orders and continuing foreclosure reviews. The agencies have taken a number of steps to ensure that borrowers are aware of the amendments to the Consent Orders. For example, the agencies have:

- Met with and sought feedback from community groups, housing counseling organizations, and other interested stakeholders, and incorporated that feedback into communications to borrowers about the amendments to the Consent Orders, including a postcard for the paying agent, Rust Consulting, Inc., to mail to borrowers whose servicers are parties to the amendments to the Consent Orders to alert borrowers that they would be receiving a payment. The agencies received valuable input that helped improve readability;
- Developed a letter to accompany payments to borrowers whose servicers are parties to the amendments to the Consent Orders. This letter contains an explanation about why the borrower is receiving a payment, along with instructions for cashing the check, a statement that the borrower is not required to execute a waiver of any legal claims they may have against their servicer as a condition for receiving payment, and other important disclosures;
- Presented a webinar on March 13, 2013, directed at community groups, housing counselors and other interested members of the public to explain the provisions of the amendments to the Consent Orders;
- Presented a webinar on April 30, 2013, for NeighborWorks America and its member organizations to explain the provisions of the amendments to the Consent Orders; and
- Issued several press releases related to the amendments to the Consent Orders and made publicly available on their Web sites information about how cash payment amounts were determined, the numbers of borrowers falling into the various payment categories, and the schedule for mailing checks to borrowers whose servicers participated in the agreements in principle.⁶

In addition, the Federal Reserve is regularly updating its Web site with the number and dollar value of checks to borrowers whose servicers are parties to the amendments to the consent orders that have been deposited or cashed. The Federal Reserve and the OCC have also committed to providing public reports that detail the implementation of the amendments to the consent orders. We anticipate the reports will include available details about the direct relief and other assistance provided to homeowners, as well as informa-

⁶When available, the Board intends to make similar information available to borrowers whose mortgages were serviced by GMAC Mortgage, which only recently agreed to make payments to all such borrowers in lieu of the IFR.

tion about the findings of reviews where complete, number of requests for review, costs associated with the reviews, and the status of the other corrective activities directed by the enforcement actions. We are in the process of analyzing this information at this time and, as suggested above, are taking steps to determine how this information may be best presented to the public.

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR BROWN
FROM DANIEL K. TARULLO**

Q.1. A critical element of the proposed new Basel leverage ratio is the definition of the denominator (the assets subject to the leverage requirement). A denominator definition that permits too many bank commitments to remain off the balance sheet and uncapitalized could undermine the benefits of a higher leverage ratio requirement.

Have the banking agencies made a quantitative examination of the change in bank assets subject to the leverage requirement that will be created by the new Basel leverage rules?

Could you please inform us, for the six largest U.S. banks and bank holding companies, the approximate amount of total assets that would be counted for the denominator of leverage capital requirements under the following definitions of assets: U.S. GAAP, IFRS accounting, and the proposed Basel leverage ratio definition.

What factors are most important in determining the difference between GAAP and IFRS accounting and the proposed Basel leverage ratio definition? What is the total amount of the difference accounted for by: Changes in off-balance sheet treatment of credit commitments that are not derivatives contracts and changes in derivatives netting and offset rules.

To the degree possible, please include breakdowns of the impact of the relevant sub-changes in each of these areas, as well as written explanations of the areas in the Basel leverage ratio definition that account for the differences.

A.1. In January 2014, the Basel Committee on Banking Supervision (the BCBS) issued a revised international leverage ratio standard (the revised BCBS standard) that replaces the standard issued in December 2010. The denominator of the leverage ratio (total exposure) continues to include on-balance sheet assets and off-balance sheet exposures, including unfunded commitments, guarantees, derivative exposures, and securities financing transactions.

Compared to the December 2010 standard, under the revised BCBS standard, certain off-balance sheet items will be included in the total exposure using the same credit conversion factors as those used in the standardized approach to risk-based capital, with one exception. To ensure that all unfunded commitments are included in the total exposure, unconditionally cancelable commitments (e.g., credit card lines) will receive a credit conversion factor of 10 percent rather than the zero percent specified in the standardized approach to risk-based capital. While the revised BCBS standard reduces exposure amounts for certain off-balance sheet items that received a 100-percent credit conversion factor under the 2010 standard, the revised BCBS standard increases exposure amounts for se-

curities financing transactions and written credit derivatives, as discussed further below, and also clarifies the treatment of cash variation margin in derivatives transactions.

The denominator of the BCBS standard, total exposure, is the same irrespective of whether a banking organization uses U.S. GAAP or IFRS. While there are some differences between U.S. GAAP and IFRS in the amount of balance-sheet netting permitted for derivatives and securities financing transactions, the revised BCBS standard would neutralize these differences by requiring all banking organizations to treat such exposures in a consistent manner. For example, U.S. GAAP permits netting of derivatives and related cash variation margin if the transactions are covered by qualifying master netting agreements and certain other criteria are met. However, the IFRS netting criteria are more restrictive than U.S. GAAP, and therefore, allow less balance-sheet netting. The revised BCBS standard clarifies that, regardless of the accounting standard used, a bank may net both derivatives and related cash variation margin if certain criteria are met. This will result in institutions that use U.S. GAAP and institutions that use IFRS reporting similar values for these exposures.

The revised BCBS standard also includes an additional exposure amount for written credit derivatives. These would be included in the total exposure at their notional amount, a treatment that exists in neither U.S. GAAP nor IFRS, both of which use mark-to-market value as the basis for reporting. The inclusion of the notional amount of written credit protection, offset to some degree by bought credit protection in the same name of equal or greater maturity, results in a significant amount of added exposure to the denominator relative to the 2010 standard for the largest U.S. banks.

U.S. GAAP and IFRS have some differences with regard to the extent to which a bank can offset assets and liabilities in securities financing transactions with the same counterparty but a recent change in IFRS made the accounting of these transactions similar to U.S. GAAP. The revised BCBS standard permits limited netting for securities financing transactions if certain criteria are met, similar to both accounting frameworks. Compared to the 2010 standard, the revised BCBS standard would increase the exposure amount for securities financing transactions that is included in the total exposure while maintaining equivalence across U.S. GAAP and IFRS reporters. There are no other significant accounting differences between U.S. GAAP and IFRS that would impact the amount of institutions' total exposure.

The U.S. Federal banking agencies are participating in ongoing international discussions and a confidential quantitative impact study analysis of the revised BCBS standard. The U.S. agencies are also examining the potential impact of the revised BCBS standard on U.S. banking organizations. Since U.S. institutions report financial data based on U.S. GAAP, it would be imprecise to try to estimate the amount of the U.S. banking organizations' total assets under IFRS. If the total exposure is calculated under the revised BCBS standard but no netting is permitted for derivatives and securities financing transactions, the total exposure for the six largest U.S. bank holding companies would increase by a percentage ranging between 1 percent and 15 percent, depending on the bank-

ing organization's business model. On average, total exposure would increase by approximately 9 percent for these institutions, if netting is not permitted for derivatives and securities financing transactions.

Q.2. The new leverage ratio proposals mandate a leverage ratio of 6 percent for large bank subsidiaries, but a lower 5-percent ratio for the overall holding company. What policy justification is there for this distinction between the bank and the holding company?

A.2. Under the final and interim final capital rules issued by the agencies in 2013 (2013 capital rule), certain large depository institutions and bank holding companies to which the advanced approaches requirements are applicable are subject to a minimum supplementary leverage ratio of 3 percent.¹ On July 9, 2013, the Federal banking agencies proposed to implement enhanced supplementary leverage ratio standards that would apply to bank holding companies with total consolidated assets of more than \$700 billion or assets under custody of more than \$10 trillion (covered BHCs), as well as their insured depository institution subsidiaries.² Under this proposal, in order to avoid limitations on distributions and discretionary bonus payments, covered BHCs would need to hold a leverage buffer of tier 1 capital in an amount greater than 2 percent of its total leverage exposure, in addition to the minimum supplementary leverage ratio requirement of 3 percent. This proposed buffer standard is similar to the capital conservation buffer for the risk-based capital ratios in the final capital rule.³ Under the proposal, insured depository institution subsidiaries of covered BHCs would be subject to a 6-percent supplementary leverage ratio to be well-capitalized under the prompt corrective action framework.⁴

As explained in the proposal, the agencies calibrated the proposed standards so that they would remain in an effective complementary relationship with the strengthened risk-based capital standards included in the 2013 capital rule. By setting the minimum supplementary leverage ratio plus leverage buffer at 5 percent for covered BHCs, and the well-capitalized threshold for insured depository institution subsidiaries of covered BHCs at 6 percent, the proposal is structurally consistent with the current relationship between the leverage ratio requirements applicable to insured depository institutions and BHCs under section 10 of the 2013 capital rule. Under that provision, insured depository institution subsidiaries must maintain at least a 5-percent leverage ratio to be well-capitalized for prompt corrective action purposes, whereas BHCs must maintain a minimum 4-percent leverage ratio under separate BHC regulations.

¹ Advanced approaches requirements generally apply to an institution with consolidated total assets on its most recent year-end regulatory report equal to \$250 billion or more, or consolidated total on-balance sheet foreign exposure on its most recent year-end regulatory report equal to \$10 billion or more. See also, 78 FR 62018 (October 11, 2013) available at <http://www.gpo.gov/fdsys/pkg/FR-2013-10-11/pdf/2013-21653.pdf>.

² See, 78 FR 51101 (August 20, 2013) available at <http://www.gpo.gov/fdsys/pkg/FR-2013-08-20/pdf/2013-20143.pdf>.

³ See, section 11 of the 2013 capital rule.

⁴ In order to be "adequately capitalized" under the prompt corrective action framework in the 2013 capital rule, these insured depository institutions must meet the 3-percent minimum supplementary leverage ratio requirement.

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR WARREN
FROM DANIEL K. TARULLO**

Q.1. Has your agency done any studies on the costs and benefits of allowing banks to book derivatives in depositories?

A.1. Banks book derivatives in a variety of legal entities. A number of different factors can affect a bank's booking practices such as regulatory factors, customer preference, and funding costs. We have not conducted a study that specifically quantifies potential costs and benefits of booking derivatives in depositories.

Q.2. A number of derivatives experts, including Frank Partnoy and Satyajit Das, contend that a large percentage of complex OTC derivatives, including credit default swaps, are not used for commerce but for economically unproductive activities such as gaming accounting and tax rules or hiding losses. Have you ever taken a large sample of derivatives transactions to see if these charges have validity? If the charges are accurate, in what ways would you change your views about derivatives regulation?

A.2. The Board has access to several data sources on derivative transactions entered into by bank holding companies. These data are informative about the size and nature of the derivative exposures but are not informative about the motivation behind such transactions. Moreover, bank holding companies play a significant intermediation role in the derivatives market. The specific motivation of counterparties such as asset managers, insurance companies, and nonfinancial corporates that engage in derivative transactions with bank holding companies cannot be determined from these data as it is not possible to observe any of the other economic exposures or considerations that motivate the derivative transactions themselves.

Q.3. Treasury Lew recently stated, "if we get to the end of this year and we cannot with an honest straight face say that we have ended Too Big To Fail, we're going to have to look at other options." Do you agree?

A.3. Since 2008, the United States and the international regulatory community have made meaningful progress on policy reforms to reduce the moral hazard and other risks associated with financial firms perceived to be too big to fail. In broad terms, these reforms seek to eliminate too-big-to-fail in two ways: (1) by reducing the probability of failure of systemic financial firms through stronger capital and liquidity requirements and heightened supervision, and (2) by reducing the systemic impact on the broader system of the failure of such a firm, including by improving the resolvability of systemic financial firms. In the United States, the U.S. banking agencies have implemented the Basel III capital rules and are working actively on implementing the Basel III liquidity rules. The Federal Reserve has established a robust stress testing framework for large banking organizations and has created a Large Institution Supervision Coordinating Committee to strengthen the supervision of the most systemic U.S. financial firms. The Federal Reserve also is in the process of implementing a broad set of enhanced prudential standards and early remediation requirements for large U.S. bank holding companies and foreign banks with U.S. operations.

The United States has made substantial progress since the crisis in improving the resolvability of systemic financial firms. The core areas of progress include (i) adoption and implementation of statutory resolution powers, (ii) adoption and implementation of resolution planning requirements, (iii) increased international coordination efforts, and (iv) the foreign bank regulatory requirements proposed by the Federal Reserve. The Federal Reserve supports the progress made by the FDIC in implementing Title II of the Dodd-Frank Act, including, by developing the single-point-of-entry (SPOE) approach to resolution of a systemic financial firm. Developing an approach to resolutions under Title II, such as SPOE, represents an important step toward ending the market perception that any U.S. financial firm is too big or too complex to be allowed to fail. More work remains to be done to maximize the prospects for an orderly resolution of a systemic financial firm, but we have made much progress in the past few years.

Despite this considerable progress in addressing too-big-to-fail, we have not yet adequately addressed all the vulnerabilities that developed in our financial system in the decades preceding the crisis. As I have noted, I believe that more is needed, particularly in addressing the residual risks posed by short-term wholesale funding markets, which have the continuing potential to aggravate the too-big-to-fail problem.

Q.4. The agencies have proposed increasing the leverage ratio for very large bank holding companies to 5 percent, and for depositories to 6 percent. These “supplementary” ratios are calculated using U.S. GAAP accounting measures. This means that total on-balance-sheet assets include only the net value of derivatives positions. If derivatives were accounted for under IFRS, which limits derivatives netting, then their total assets would be substantially higher. (*See, for example, the analysis of the quantitative impact of different accounting rules done by ISDA: at <http://www2.isda.org/functional-areas/research/studies/>.*)

Does the proposed increase in the leverage ratio do more than bring the U.S. leverage requirement roughly into line with the 3-percent leverage ratio that will be applied by EU regulators to all banks?

Should the GAAP/IFRS difference and implications be detailed and addressed in the rulemakings? If not, why not?

Have you compared the proposed leverage ratios to the losses experienced by banking institutions during the financial crisis?

Why is there a distinction between the leverage ratio for bank holding companies and depositories?

A.4. The recent proposal to establish enhanced leverage ratio standards for the largest, most complex bank holding companies (covered BHCs) and their subsidiary insured depository institutions (IDIs) builds on the 3-percent minimum supplementary leverage ratio requirement (minimum supplementary leverage ratio) that the Federal banking agencies established earlier this year in the final rule that revised regulatory capital standards. The minimum supplementary leverage ratio implements the leverage ratio adopted by the Basel Committee on Banking Supervision (the BCBS)

(the Basel III leverage ratio) for banking organizations subject to the agencies' advanced approaches risk-based capital rules.

The minimum supplementary leverage ratio is a measure of tier 1 capital (the numerator) to total leverage exposure (the denominator), which includes both on-balance sheet assets and off-balance sheet exposures. The BCBS designed the total leverage exposure measure so that it could be calculated in a comparable manner across jurisdictions, adjusting for any differences in accounting standards. In June 2013, the BCBS proposed modifications to the calculation of total leverage exposure that would further standardize and clarify the calculation of exposure amounts for derivatives and securities financing transactions. The agencies are continuing to work with the BCBS to assess the Basel III leverage ratio, including its calibration and design, and will consider making changes to the supplementary leverage ratio as the BCBS revises the Basel III leverage ratio.

Because the minimum supplementary leverage ratio already mitigates to a large extent the differences in accounting standards, the agencies' proposed enhanced supplementary leverage ratio standards would generally be more stringent than the international standard because they would require covered BHCs to hold 5-percent tier 1 capital to total leverage exposure in order to avoid limits on capital distributions and discretionary executive bonus payments. The proposed enhanced supplementary leverage ratio standards would also require subsidiary IDIs of covered BHCs to hold 6-percent tier 1 capital to total leverage exposure in order to be "well capitalized" under the Prompt Corrective Action (PCA) framework. These proposed enhanced standards for covered BHCs are consistent with section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which requires the Board to establish enhanced capital standards for large bank holding companies that increase in stringency based on the risk they pose to the U.S. financial system.

The agencies have taken into account various factors in developing the enhanced leverage ratio standards, including the amounts of regulatory capital held by financial institutions during the crisis and the complementary nature of the risk-based and leverage capital ratios. Based on the agencies' analysis, approximately half of the covered BHCs in 2006 would have met or exceeded a 3-percent minimum supplementary leverage ratio at the end of 2006, and the other half would have been close to meeting this requirement. This suggests that the minimum requirement would not have placed a significant constraint on the pre-crisis buildup of leverage at the largest institutions. The agencies believe that there could be benefits to financial stability and reduced costs to the deposit insurance fund by requiring the largest, most complex banking organizations to meet the enhanced leverage ratio standards. To enhance the safety and soundness of these most systemically important banking organizations, the risk-based and leverage capital requirements should work together so that each standard can offset potential weaknesses of the other.

Further, to maintain an effective complementary relationship of both regulatory capital standards, the agencies believe that enhanced leverage ratio standards should be more closely calibrated

to the strengthened risk-based capital standards and the enhanced PCA standards included in the 2013 capital rule. The proposed calibration for covered BHCs and their IDIs is structurally consistent with the current relationship between the leverage ratio requirements applicable to IDIs and BHCs under section 10 of the 2013 capital rule, under which IDIs must maintain a 5-percent generally applicable leverage ratio to be well capitalized for PCA purposes, whereas BHCs must maintain a minimum 4-percent generally applicable leverage ratio under separate BHC regulations. The agencies' proposal specifically seeks feedback on the appropriateness of the proposed calibration.

The agencies are currently reviewing public comments on this and all other aspects of the enhanced leverage ratio standards proposal and will take into account all the comments received in any final rulemaking.

Q.5. Under 12 U.S.C. 1818(e), Federal banking agencies may remove "institution-affiliated parties" from participation in the affairs of an insured depository when they directly or indirectly violate banking laws or regulations. Were officers or directors of any bank that was party to the mortgage servicer settlements removed because they directly or indirectly participated in the violations that led to the settlements? If no officer or director was removed, can you explain why?

A.5. The Federal Reserve has not issued prohibition orders against officers or directors at the banking organizations subject to mortgage servicing related enforcement actions for the conduct that led to those actions. The Federal Reserve and other Federal banking agencies have statutory authority to remove and prohibit insiders from participating in the banking industry, but in doing so must meet the high standard established by Congress. To prohibit an individual from participating in the banking industry under 12 U.S.C. 1818(e), the Federal Reserve must prove not only that the individual engaged in an unsafe or unsound practice, breach of fiduciary duty or violation of law, but also that this misconduct resulted in losses or other harm to the institution or gains to the individual, and involved personal dishonesty, or willful or continuing disregard for safety and soundness. 12 U.S.C. 1818(e)(1). Decisions on whether to initiate actions to ban individuals from banking are based on whether each of these statutory criteria are met with respect to the conduct of a particular institution-affiliated party based on the individual factual record relating to a particular case.

The Federal Reserve has required the servicers it regulates to implement action plans to correct the servicing and foreclosure deficiencies that led to the enforcement actions against the servicers. We are in the process of validating the servicers' compliance with these plans. If conduct that meets the statutory criteria for a prohibition is uncovered, we will take appropriate action against the individuals involved.

Q.6. How do you audit large bank IT systems to determine potential systemic risk?

A.6. The Federal Reserve has taken a number of steps to strengthen its ongoing supervision of the largest, most complex banking firms as a result of lessons learned from the financial crisis. Most

importantly, we established the Large Institution Supervision Coordinating Committee (LISCC), to ensure that large institution supervision is more centralized; involves regular, simultaneous, horizontal (cross-firm) supervisory exercises; and is more interdisciplinary than it has been in the past. The committee includes senior Federal Reserve staff from the research, legal, and other divisions at the Board, and from the markets and payment systems groups at the Federal Reserve Bank of New York, as well as senior bank supervisors from the Board and relevant reserve banks. To date, the LISCC has developed and administered a number of horizontal supervisory exercises, notably the capital stress tests and related comprehensive capital reviews of the Nation's largest bank holding companies, and is now extending its activities to coordinate other supervisory processes more effectively.

The largest banking institutions also are subject to continuous supervision by the Federal Reserve that includes resident teams of on-site examiners. This level of supervisory oversight incorporates review of internal management reports, periodic meetings with the personnel responsible for managing and controlling the risks of the firm, and additional discovery and targeted examinations of the firm's activities. Discovery reviews are conducted when a new business line or product is released, the firm's operating environment changes, or gaps exist in supervisors' understanding of the financial institution's risk profile. Targeted reviews are conducted to more closely analyze a specific risk area, determine the quality of internal risk assessments, and evaluate mitigating controls.

Additionally, enhanced continuous monitoring (ECM) focuses on information security, business resilience, project management, and key initiatives related to core settlement and clearing activities. The ECM approach is used to develop supervisory assessments at systemically important financial institutions and financial market utilities. Federal Reserve supervisors also leverage interagency examination reports and internal and third-party audit reports. Supervisors select examination strategies based on a bank's risk profile and historical risk management capabilities.

Throughout the year, examiners gather information from individual firms and evaluate this information for common trends or concerns that may pose a systemic risk to the financial system. When emerging threats or concerns are deemed material, supervision staff and management conduct a focused review across a number of banks to obtain more detailed information for additional analysis.

Increased reliance on technology service providers and interconnectivity with other banks and entities has significant implications for the identification and management of systemic risk. Technology advances and cost pressures have driven banks to consolidate core processing systems and to initiate projects to deliver services more efficiently. Supervision staff and management monitor IT risks, such as information security, cybersecurity, and operations resiliency, at large banks and adjust supervisory efforts based upon evolving threats.

Q.7. The U.S. Chamber of Commerce has called for a trade review of the Volcker Rule, alleging that the rule violates trade agreements. Has your agency done any legal analysis of whether pend-

ing or prior trade pacts would vitiate its ability to impose higher capital requirements on SIFIs?

A.7. It is well recognized that the Basel Capital Accords establish minimum capital standards for internationally active banking organizations. National supervisors are free to require higher capital for their organizations than the Basel minimum standards. None of this would violate any trade obligations of the United States. Pending and prior trade agreements impose certain obligations on the United States relating to foreign financial institutions, including financial institutions that are designated as SIFIs. Relevant obligations include permitting market access and applying national treatment and most-favored-Nation treatment to foreign financial institutions subject to the Board's jurisdiction. Board staff does not believe that imposing higher capital requirements on financial institutions that are SIFIs would violate any of those trade obligations. Moreover, even if any of those trade obligations were implicated by higher capital requirements, all relevant trade agreements permit the United States to adopt or maintain measures for prudential reasons. Staff believes the imposition of higher capital requirements to assure the safety and soundness of banking organizations is the exemplary case of a prudential measure. Accordingly, Board staff does not believe U.S. trade agreements relating to financial services would vitiate the ability of the United States to impose higher capital requirements on financial institutions that are SIFIs.

Q.8. Has your agency performed any studies or prepared any estimates of the profit subsidy banks derive from carrying derivatives in depositories?

A.8. We have not attempted to quantify the earnings impact of moving positions out of the depository institution. It is difficult to estimate the subsidy associated with bank engagement in derivatives activities because of the heterogeneity of the different firms and their derivatives businesses. One challenge to an analysis of this sort is that some firms that hold derivatives outside of the depository institution have self-funding derivatives business, and thus do not require additional funding to meet collateral requirements. In other words, collateral collected is sufficient to meet collateral posting needs. Another challenge is that some clients prefer facing the depository institution, and it would be difficult for us to predict how clients would respond to not having this as an option.

Q.9. Certain aspects of the U.S. payments system lag international standards by a substantial margin. For example, the U.S. still uses magnetic strip technology for credit and debit cards, while in Europe, Asia, and even emerging markets like South Africa, more secure chip cards (smart cards) have been widely used since the late 1990s. South Africa has also used cards for paying unbanked laborers starting in the 1990s, and at much lower fee levels than American banks charge. Can you explain how a less advanced country with much smaller banks can run an apparently more efficient payment system than the U.S.?

A.9. The United States has established infrastructure that supports several ubiquitous payment systems, including wire, ACH, check, and card payments. The U.S. payments system provides a

solid foundation for payment services; however, some of these systems are not universally fast or efficient from an end user perspective by today's standards. The challenge for the payment industry is to provide a payment system for the future that combines the valued attributes of existing payment methods—convenience, safety, and universal reach at low cost to the end user—with new technology that enables faster processing and enhanced convenience. In deciding how to accomplish this in the United States, stakeholders are not starting from an undeveloped payment environment like some other economies that have adopted new payment technologies in the last 10 to 20 years.

Industry stakeholders have made substantial capital investments over many decades into the existing payment system, and closely analyze the costs and benefits of investment proposals. For example, whether smart card technology will yield positive net societal benefits in the United States is an open issue with payment experts on both sides of the debate. Smart card technology was introduced in some countries largely to reduce counterfeit fraud. Implementation in the United States, however, would require significant changes to an established payment infrastructure that would cost stakeholders billions of dollars, would not necessarily improve efficiency, and would not address “card not present” fraud in mail, telephone, and Internet transactions. On the other hand, as other countries embed smart card technology into their payment infrastructure, U.S. card holders may increasingly experience challenges with using their magnetic-stripe cards outside the United States. Nevertheless, several major card networks have taken steps to implement smart card technology in the United States over the next several years.

Nearly all stakeholders are willing to work toward a more efficient payments system, and agree that improvements are necessary and appropriate in some cases. However, views on what constitutes a more efficient system and what risks within that system are appropriate vary across the payment industry, which includes over ten thousand depository institutions, operators, processors, service providers, and end users.

Q.10. In your testimony, you emphasized the risks created by short-term funding markets. In this context, you stated that you felt regulators should consider: “possible additional steps in areas such as securities financing transactions to address the potential for runs in short-term funding regardless of whether the borrower is a large regulated institution.”

Has the Federal Reserve investigated the extent to which systemic risks in short-term funding markets may be created by institutions that are not currently prudentially regulated by the Federal Government? Is the data currently available to the Federal Reserve (including through its participation in FSOC) adequate to answer this question?

Do you believe that serious systemic risks may be created by institutions that are not currently prudentially regulated but participate heavily in short term funding markets? If so, what steps are you taking to coordinate with other agencies such as the SEC and with the FSOC to address these risks?

A.10. As the experience of the financial crisis shows, large portfolios of assets can be funded with short maturity liabilities entirely outside of the regulated banking industry; indeed, in some cases without any explicit support from any institution, whether regulated or not. Measures taken since the crisis, including those by banking regulators who have taken concrete steps to require that financial institutions hold capital and liquidity against the risks stemming from off-balance sheet activities, have contributed to the disappearance of some of the most pernicious structures engaging in such maturity transformation during the pre-crisis period. But it is also clear that there is potential over time for new structural and transactional forms to emerge, particularly as regulation of the core banking system become more comprehensive and effective.

Thus the Federal Reserve is acutely focused on the role that a variety of institutions and markets play in providing short-term funding, whether or not they are prudentially regulated by a Federal agency. We are actively gathering relevant information in a variety of ways. On September 19, 2013, the Federal Reserve proposed collecting highly granular data on the liquidity positions of large complex financial institutions, including information on securities financing, repurchase agreements and securities financing transactions with a host of bank and nonbank counterparties. We sought public comment on these collections and look forward to finalizing them soon. (Proposed collections FR 2052a and FR 2052b; for more information see http://www.federalreserve.gov/reportforms/formsreview/FR2052a_FR2052b_20130919_ifr.pdf.)

As part of its work with the FSOC, the Federal Reserve has obtained information on the liquidity positions of a number of large, complex nonbank financial institutions. Indeed, the FSOC's bases for designating American International Group, Inc., General Electric Capital Corporation, Inc., and Prudential Financial, Inc. as systemically important nonbank financial companies referenced inter alia their reliance on a variety of nondeposit funding sources that could be withdrawn by investors, potentially putting pressure on the institutions to rapidly liquidate large portfolios of assets.

We are committed to continuing our efforts to gather information on potential pressure points in short-term funding markets and to address them. We will continue to work with other relevant agencies, including other members of the FSOC, to put in place structural reforms to reduce the likelihood and magnitude of runs.

In that vein, I and others at the Federal Reserve have highlighted the continuing systemic vulnerabilities posed by MMFs, which are susceptible to destabilizing runs. We continue to engage through the FSOC with the SEC and other agencies with the goal of enhancing the resilience of these vehicles, which are important to households and businesses as well as short-term funding markets.

Q.11. In your response to Chairman Johnson's question regarding the regulatory treatment of insurance companies, you stated that insurance companies tended to hold long-term liabilities and that there was "not a way to accelerate the run of that funding." Although this is true for many insurance liabilities, insurance compa-

nies do sell products whose liabilities are closely linked to returns in the broader financial sector. These include financial guarantee products, insurance products with redemption features, and variable annuities that include guarantees. Has the Federal Reserve examined the magnitude of these activities in the insurance sector and their potential for creating systemic risk? What have been the results of this examination?

A.11. There is a range of opinions on the question of the extent to which insurance companies pose a systemic risk. Ultimately, the Financial Stability Oversight Council (FSOC) is charged under the Dodd-Frank Act with making firm-specific determinations regarding the systemic risk posed by a nonbank financial firm, including an insurance company. For these FSOC determinations, the question of systemic risk in the insurance sector has to be answered within the context of a specific firm and an evaluation of its size, product mix, activities, interconnectedness with other financial companies, and other factors set forth in the Dodd-Frank Act and FSOC guidance.

Generally speaking, traditional insurance companies tend to have lower levels of leverage and liquidity risk, and engage in less maturity transformation, relative to banking firms. However, it is also true that many insurance companies, particularly life insurers, have progressively moved toward investment products that more closely resemble banking products (e.g., annuities, guaranteed investment contracts, and other investment products that have withdrawal features and/or guarantee a minimum market return). In addition, some insurance companies have become active participants in the financial markets, including the same securities lending and financing markets relied on by banking and securities firms. These activities have introduced into the operations of some insurance companies an increasing level of liability liquidity, financial risk and interconnectedness with the financial system.

Q.12. In your testimony, you stated that “The Section 716 [swaps push out] rule is done.” The Federal Reserve released a rule in June governing temporary (2-year) extensions to the deadline for compliance with Section 716 for both U.S. and foreign banking organizations, but I was not aware of any proposed rule or guidance issued by the banking agencies concerning how to come into full compliance with all the requirements of Section 716.

By stating that the Section 716 rule is done, did you intend to indicate that Section 716 is self-enforcing in statute and no additional rulemaking is necessary for the final post-extension deadline of 2015? If not, when do you plan to issue guidance to banking organizations concerning full compliance with Section 716?

Has the Federal Reserve begun any process of working with banks to determine that they will be fully prepared to comply with Section 716 by the end of any extension period?

A.12. Section 716’s prohibition will come into effect on July 16, 2015, for most affected entities. The statute is self-effectuating and does not require the Board to issue implementing regulations or guidance. During the transition period, the Board will work with banking organizations to facilitate their compliance with section 716 and will consider whether further guidance is appropriate.

Q.13. How many firms are engaged in trading of physical commodities using the authority under section 4(o) in 12 U.S.C. 1843? How does the Federal Reserve track this activity?

A.13. Two firms are engaged in trading of physical commodities using the authority under section 4(o) of the Bank Holding Company Act (12 U.S.C. 1843(o)). As part of its ongoing work supervising bank holding companies, Federal Reserve staff seeks to understand the full range of commodities activities currently conducted by these companies, assess their risk management practices for these activities, and assess the potential impact of commodities activities on their financial condition. The supervisory oversight includes review of internal management reports, periodic meetings with the personnel responsible for managing and controlling the risks of the firm's commodities activities, and targeted examinations of those activities.

Q.14. Why hasn't the Federal Reserve mandated real-time check clearing for domestic transactions?

A.14. Over the past decade, the payment industry has undergone an almost complete transition from paper-based to electronic check clearing. For example, in 2005, approximately 5 percent of checks sent to Reserve Banks for collection were cleared electronically while today over 99.95 percent of checks sent to Reserve Banks for collection are in electronic form. This transition has greatly reduced the time and cost of check clearing. In addition, banks have introduced innovations to end users allowing the electronic capture and deposit of checks remotely, increasing convenience of the check instrument. It is unclear, however, that the additional efficiencies that could be gained with real-time check clearing would justify the cost of the required changes to the check clearing system.

The payment industry is evaluating opportunities to improve the speed of payment clearance and settlement but generally with respect to other payment instruments. On September 10, the Federal Reserve Banks issued for public consultation a paper (www.FedPaymentsImprovement.org) discussing the Federal Reserve's vision for improving the speed and efficiency of the U.S. retail payments system on an end-to-end basis while maintaining payment system safety. The paper identifies key gaps and opportunities in the U.S. payment system and desired outcomes that close these gaps and capture these opportunities. One desired outcome calls for ubiquitous electronic solution(s) for making retail payments whereby funds are debited from the payer and credited to the recipient on a near-real-time basis. The paper requests industry feedback on several potential ways to achieve a near-real-time retail payment system, including a separate wire transfer-like system, enhancements to the automated clearing house system, modifications to debit card networks, or development of an entirely new payment system.

The paper invites payment-industry and end-user input on the gaps, opportunities, and desired outcomes articulated in the paper as well as potential strategies and tactics to shape the future of the U.S. payment system. The Federal Reserve plans to consider this input as it assesses how to best foster improvements that advance the speed, efficiency, and security of the Nation's payments system.

Q.15. Can the Fed use access to Fedwire or other payment systems as a mechanism for promoting soundness of firms that rely on the Fed's "lender of the last resort" dollar facilities?

A.15. The promotion of safe and sound financial institutions is the foremost objective of financial regulation. The Federal Reserve and the other banking regulators have a broad range of supervisory and regulatory authorities designed to assess and promote the soundness of depository institutions. These authorities include the ability to compel corrective actions through a variety of escalating enforcement mechanisms.

The Reserve Banks' provision of accounts and payment services to depository institutions occurs in the context of this larger U.S. regulatory and supervisory framework for depository institutions. In particular, the Federal Reserve has a well-developed set of policies and a framework for monitoring the financial condition of depository institutions that maintain accounts at the Reserve Banks in order to limit risks to the Reserve Banks. Such monitoring incorporates supervisory reports and capitalization data, among other information. These policies also provide for placing progressively more restrictive conditions on a depository institution's use of Reserve Bank payment services as its financial condition deteriorates. For example, a depository institution may be required to post collateral, maintain certain minimum balances, pre-fund certain payment transactions, or be limited in the services it may access. These potential limitations on access to the payment system for depository institutions along with supervisory measures provide a strong incentive for depositories to avoid a significant deterioration in their financial condition.

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR CRAPO
FROM MARTIN J. GRUENBERG**

Q.1. In late 2011, the agencies issued a highly complex and lengthy regulatory proposal to implement the Volcker rule. In February of this year, Chairman Bernanke testified that while regulators have made a lot of progress on the rule, the issues slowing the process "are finding agreement and closure among the different agencies" When can we expect the final rule? What are the reasons for a delay?

A.1. The Volcker Rule rulemaking involves the bank regulatory agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission (the agencies). The agencies received more than 18,000 comment letters on the Volcker Rule proposal, including hundreds that were very detailed and highly technical. We are committed to carefully considering all views expressed during the comment process as we finalize the rule. The agencies are striving to have the rule completed by year end 2013.

Q.2. Your agencies published a short guide for smaller, less complex institutions so they can understand and implement the final Basel III rule. Both of your agencies, together with the FRB, took additional steps to analyze and mitigate the burden of the proposed rule on community banks before promulgating final rules. What steps is your agency taking to ensure that its bank examiners and

regional office staff properly interpret and apply the Basel III regime for community banks versus larger banks?

A.2. Internally, the FDIC is holding training sessions for examination and other key supervisory staff on the interim final capital rule. To date, we have trained regional specialists who serve as points of contact on Basel III in our six regional offices (New York, Atlanta, Dallas, Kansas City, Chicago, and San Francisco) and hosted a training conference call with capital markets subject matter experts in our field office locations. We have established an internal Web site for FDIC examiners and staff where we are providing critical information and training materials on Basel III.

The information on our public Web site includes the interagency community bank guide, an expanded community bank guide developed by the FDIC, and instructional videos. We held outreach sessions for bankers in our six regional offices in August, and the FDIC hosted a national call on August 15, 2013, to review common questions on the interim final rule raised during outreach sessions. The national call was advertised to financial institutions during outreach sessions and through a Financial Institution Letter and to FDIC examination and supervisory staff through a global email.

Formal assessment of FDIC examiner training is underway to ensure the curriculum sufficiently reflects the new interim final capital rule. On an interagency basis, the FDIC participates on the Federal Financial Institutions Examination Council (FFIEC) course development teams, and the FFIEC is reviewing training updates that will be required to reflect and educate examination staff on the new capital rules.

Q.3. On July 9th the FDIC board approved the Basel III rules on interim basis and, together with the FRB and the OCC, issued a proposed rule to increase the leverage ratio for the eight largest banking organizations beyond the Basel III levels. Should banks below the \$700 billion threshold worry about the trickle-down effect of the proposed approach?

A.3. The proposed enhanced supplementary leverage ratio would apply to banking organizations with \$700 billion or more in total consolidated assets or \$10 trillion or more in assets under management. It was intentionally focused on the eight most systemically significant financial institutions and not on smaller or less complex institutions that do not present the same degree of systemic risk.

Q.4. The FDIC's proposal calls for a supplementary leverage ratio of 5 percent for large bank holding companies and 6 percent for the banks that are owned by those holding companies. The rules proposed by the FDIC would apply to 8 largest U.S. banks and exceed standards set by the Basel III international accord. Are European regulators considering similar requirements for large EU-based banks since most of the 10 largest banks in the world are based out of Europe? If European regulators are not considering similar standards for their large banks, what effect would FDIC's proposal have on the competitiveness of the U.S. banks abroad?

A.4. While Basel III establishes an international leverage ratio for the first time, there is no indication at this time that other jurisdictions would propose leverage standards beyond the minimum provided in the Accord. However, U.S. banks have long been subject

to prompt corrective action standards that include minimum requirements based on a leverage ratio, while European banks until now have not been subject to such requirements. Historically, U.S. banks have fared very well relative to their European counterparts despite (or perhaps because of) being subject to higher capital standards. The financial crisis in Europe has been exacerbated in large part due to weakness in the banking sector. As such, we believe a strongly capitalized banking sector will benefit banking organizations and the economy.

Q.5. Institutions with nonbank assets greater than \$250 billion filed their resolution plans last year and must now provide a second, more comprehensive version of the living will by October 1st. How can we know that these living wills will work in the first place? What are top three significant obstacles identified by regulators in the first round of living wills that warrant additional scrutiny?

A.5. Under the framework of the “Dodd-Frank Wall Street Reform and Consumer Protection Act” (Dodd-Frank Act), bankruptcy is the preferred option in the event of the failure of a Systemically Important Financial Institution (SIFI). To make this objective achievable, Title I of the Dodd-Frank Act requires that all bank holding companies with total consolidated assets of \$50 billion or more, and nonbank financial companies that the Financial Stability Oversight Council (FSOC) determines could pose a threat to the financial stability of the United States, prepare resolution plans, or “living wills,” to demonstrate how the company could be resolved in a rapid and orderly manner under the Bankruptcy Code.

The FDIC and the Federal Reserve (the Agencies) review the 165(d) plans and may jointly find that a plan is not credible or would not facilitate an orderly resolution under the Bankruptcy Code. If a plan is found to be deficient and adequate revisions are not made, the FDIC and the Federal Reserve may jointly impose more stringent capital, leverage, or liquidity requirements, or restrictions on growth, activities, or operations of the company, including its subsidiaries. If a company does not comply with these requirements within 2 years, the FDIC and the Federal Reserve, in consultation with the FSOC, can order the company to divest assets or operations to facilitate an orderly resolution under the Bankruptcy Code.

Eleven companies submitted initial resolution plans in 2012. Following the review of the initial resolution plans, the Agencies provided additional Guidance to companies to assist in the preparation of their 2013 resolution plan submissions. The Agencies extended the filing date to October 1, 2013, to give the firms additional time to address the Guidance.

The Agencies will be evaluating how each resolution plan addresses a set of benchmarks outlined in the Guidance that pose the key impediments to an orderly resolution. The benchmarks are as follows:

- *Multiple Competing Insolvencies:* Multiple jurisdictions, with the possibility of different insolvency frameworks, raise the risk of discontinuity of critical operations and uncertain outcomes.

- *Global Cooperation:* The risk that lack of cooperation could lead to ring-fencing of assets or other outcomes that could exacerbate financial instability in the United States and/or loss of franchise value, as well as uncertainty in the markets.
- *Operations and Interconnectedness:* The risk that services provided by an affiliate or third party might be interrupted, or access to payment and clearing capabilities might be lost.
- *Counterparty Actions:* The risk that counterparty actions may create operational challenges for the company, leading to systemic market disruption or financial instability in the United States.
- *Funding and Liquidity:* The risk of insufficient liquidity to maintain critical operations arising from increased margin requirements, acceleration, termination, inability to roll over short term borrowings, default interest rate obligations, loss of access to alternative sources of credit, and/or additional expenses of restructuring.

**RESPONSES TO WRITTEN QUESTIONS OF
SENATOR MENENDEZ FROM MARTIN J. GRUENBERG**

Q.1. Over the last few months, we've seen reports in the press of so-called "regulatory capital trades", in which regulated financial institutions have purchased credit protection (often using credit default swaps) from unregulated entities (often SPVs, hedge funds, or other entities formed offshore to avoid regulation) in order to reduce the amount of capital they need to hold against an investment on their books. In effect, these trades are transferring risk from regulated institutions that are subject to capital requirements to unregulated entities that are not subject to capital requirements, and creating exposure of the regulated institution to a potential default by the unregulated entity.

If this story sounds familiar, it should—this is strikingly similar to what we saw happen with AIG before the financial crisis. These trades are transferring risk from regulated and supervised financial institutions to unregulated corners of the market, where it can build and concentrate without monitoring or supervision by regulators.

The Basel Committee has partly addressed this issue by calling for banks to properly account in their capital calculations for the costs of credit protection they purchase. But does this proposal do enough to address concerns about regulatory arbitrage and systemic risk accumulating all over again through "shadow banking"? Are you concerned about these "regulatory capital trades", and what steps are you taking to monitor and address these arrangements?

A.1. The FDIC does not condone "regulatory capital trades" that mask a bank's risk position and result in an overly optimistic portrayal of its underlying capital strength. Our examiners are aware of the issue and will scrutinize such activities during on-site examinations.

In March, 2013, the Basel Committee issued a consultative paper titled "Recognizing the Cost of Credit Protection Purchased", which

proposes changes in regulatory capital rules intended to address some of these concerns. In addition, other regulatory initiatives will help mitigate risk concerns associated with these trades. For example, many of these “regulatory capital trades” are conducted via over-the-counter derivatives. Going forward, these trades will be subject to margin requirements as well as heightened capital standards.

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR BROWN
FROM MARTIN J. GRUENBERG**

Q.1. A critical element of the proposed new Basel leverage ratio is the definition of the denominator (the assets subject to the leverage requirement). A denominator definition that permits too many bank commitments to remain off the balance sheet and uncapped could undermine the benefits of a higher leverage ratio requirement.

Have the banking agencies made a quantitative examination of the change in bank assets subject to the leverage requirement that will be created by the new Basel leverage rules?

Could you please inform us, for the six largest U.S. banks and bank holding companies, the approximate amount of total assets that would be counted for the denominator of leverage capital requirements under the following definitions of assets: U.S. GAAP, IFRS accounting, and the proposed Basel leverage ratio definition?

What factors are most important in determining the difference between GAAP and IFRS accounting and the proposed Basel leverage ratio definition? What is the total amount of the difference accounted for by: Changes in off-balance sheet treatment of credit commitments that are not derivatives contracts and changes in derivatives netting and offset rules?

To the degree possible, please include breakdowns of the impact of the relevant sub-changes in each of these areas, as well as written explanations of the areas in the Basel leverage ratio definition that account for the differences.

A.1. The banking agencies have analyzed the quantitative impact of the leverage ratio proposal. A discussion of this analysis is included in the Enhanced Supplementary Leverage Ratio notice of proposed rulemaking. In summary, our analysis indicates that, on average, the proposed supplementary leverage ratio denominator would be 1.43 times larger than total assets reported in the denominator of the longstanding U.S. leverage ratio, which is based upon U.S. GAAP.

According to Federal Reserve regulatory reporting data (FR Y-9C), which are calculated in accordance with U.S. GAAP, the largest holding companies reported total assets of: \$2.2 trillion for JPMorgan; \$2.1 trillion for Bank of America; \$1.8 trillion for Citigroup; \$1.3 trillion for Wells Fargo; \$0.9 trillion for Goldman Sachs; and \$0.7 trillion for Morgan Stanley. These and other U.S. institutions are not required to report total assets under International Financial Reporting Standards (IFRS). Accordingly, we are unable to provide the quantitative estimates of GAAP-IFRS differences requested in your letter. In general terms, however, an important difference between the two frameworks, especially from

the perspective of financial institutions active in derivatives, is that while both frameworks allow netting of derivatives under certain circumstances, in the case of IFRS, those circumstances are more limited.

It is important to note that the leverage ratio included in the Basel III agreement is calculated in a manner that is not dependent on a particular bank's accounting framework. The Basel agreement follows principles more similar to U.S. GAAP in certain areas (e.g., derivatives netting) and more similar to IFRS in other areas (e.g., the treatment of certain collateral). For example, the proposed supplementary leverage ratio denominator follows the U.S. GAAP approach for netting derivatives and securities lending and borrowing transactions. However, the proposed supplementary leverage ratio denominator includes several add-ons that are not part of U.S. GAAP or IFRS: (1) a potential future-exposure amount for derivatives; (2) off-balance sheet commitments; and (3) 10 percent of unconditionally cancelable commitments (e.g., unused credit card lines).

Q.2. The new leverage ratio proposals mandate a leverage ratio of 6 percent for large bank subsidiaries, but a lower 5-percent ratio for the overall holding company. What policy justification is there for this distinction between the bank and the holding company?

A.2. These levels are structurally consistent with the current relationship between the generally applicable leverage ratio requirements for insured depository institutions (IDIs) and bank holding companies (BHCs). Under the existing rules, IDIs must maintain a 5-percent generally applicable leverage ratio to be well capitalized for prompt corrective action (PCA) purposes, whereas BHCs must maintain a minimum 4-percent generally applicable leverage ratio under separate BHC regulations. The new standards are more stringent than the current 5-percent well-capitalized standard under PCA with respect to the generally applicable leverage ratio due to the higher calibration and inclusion of additional items in the denominator.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR WARREN FROM MARTIN J. GRUENBERG

Q.1. Has your agency done any studies on the costs and benefits of allowing banks to book derivatives in depositories?

A.1. Experience has shown that certain types of derivatives can be used to improve risk management while other types of derivatives activity appear to have elevated risks within banks or the financial system as a whole. For example, interest rate swaps have been used for more than a decade to help institutions manage interest rate risk as part of their asset liability management process. On the other hand, banks' credit default swaps activity has sometimes had the effect not of hedging risk but of elevating risk, both to individual institutions and the financial system. For example, large banks experienced significant losses on credit derivatives in 2007 and 2008; these procyclical losses appear to have amplified rather than hedged the risks facing these institutions at the time (see also the Table provided in the response to Question 11).

Q.2. A number of derivatives experts, including Frank Partnoy and Satyajit Das, contend that a large percentage of complex OTC derivatives, including credit default swaps, are not used for commerce but for economically unproductive activities such as gaming accounting and tax rules or hiding losses. Have you ever taken a large sample of derivatives transactions to see if these charges have validity? If the charges are accurate, in what ways would you change your views about derivatives regulation?

A.2. Derivatives markets are undergoing major reforms as the result of domestic regulations and international mandates. The “Dodd-Frank Wall Street Reform and Consumer Protection Act” (Dodd-Frank Act) requires significant reforms of derivatives activities. For example, under the Dodd-Frank Act certain derivatives must be cleared, margin will have to be exchanged between derivatives counterparties, certain derivatives (such as uncleared credit default swaps that are not hedging risk) will be pushed out of IDIs, and the Volcker Rule will limit proprietary trading in derivatives positions. These reforms are designed to manage systemic risk and should reduce the incentives to use derivatives to support unproductive activities such as those described by certain derivatives experts.

Q.3. Treasury Lew recently stated, “if we get to the end of this year and we cannot with an honest straight face say that we have ended Too Big To Fail, we’re going to have to look at other options.” Do you agree?

A.3. Effectively addressing “Too-Big-To-Fail” will require regulators to implement a broad range of reforms. These include additional capital requirements, enhanced prudential supervision, the reforms of derivatives regulation described in the answer to the previous question, the resolution planning procedures under Title I of the Dodd-Frank Act and the orderly liquidation authorities in Title II of the Act. While we have made significant progress on many of these reforms, there is still work to do to finalize some of them and some will require ongoing attention in the years to come.

The FDIC has devoted significant effort and resources to carrying out our new authorities under Titles I and II. The living will requirements of Title I of Dodd-Frank Act and the resolution authority of Title II of the Act are critical components to addressing “Too-Big-To-Fail.” These provisions are intended to allow for these firms to fail and be resolved in a rapid and orderly manner, without systemic disruption. Implementation of these provisions will impose accountability on systemically important financial institutions by permitting the removal of culpable management and imposing losses on shareholders and creditors of a failed company, without risk to taxpayers.

The FDIC expects to continue to make significant progress on key elements of addressing “Too-Big-To-Fail” before the end of the year. For example, the revised resolution plans for the largest, most complex financial institutions were submitted on October 1, 2013, and will be subject to review under the standards of the Dodd-Frank Act. Determination of appropriate actions to be taken will be considered by the FDIC and the Federal Reserve. In addition, the FDIC expects to release a description of the FDIC’s strat-

egy for handling the orderly liquidation of a systemically important financial institution for public comment by the end of the year. Also, the FDIC will be engaged in ongoing discussions with our international counterparts about planning and coordination regarding the failure of a large institution with international operations.

Q.4. The agencies have proposed increasing the leverage ratio for very large bank holding companies to 5 percent, and for depositories to 6 percent. These “supplementary” ratios are calculated using U.S. GAAP accounting measures. This means that total on-balance-sheet assets include only the net value of derivatives positions. If derivatives were accounted for under IFRS, which limits derivatives netting, then their total assets would be substantially higher. (*See, for example, the analysis of the quantitative impact of different accounting rules done by ISDA: at <http://www2.isda.org/functional-areas/research/studies/>.*)

Does the proposed increase in the leverage ratio do more than bring the U.S. leverage requirement roughly into line with the 3-percent leverage ratio that will be applied by EU regulators to all banks?

A.4. The Basel Committee’s agreement on the leverage ratio includes a definition of the leverage ratio denominator that is independent of a bank’s accounting framework. Therefore, a bank that calculates a leverage ratio under the Basel agreement will obtain the same result regardless of the accounting framework it uses for reporting purposes. Thus, the recently proposed U.S. leverage requirements for large, systemically important institutions are, in fact, significantly more stringent than the international 3-percent standard, irrespective of the accounting framework. If European Union regulators adopt the 3-percent leverage ratio agreed upon by the Basel Committee, they will likely do so according to the Basel Committee’s agreement, which (consistent with U.S. GAAP and, in many circumstances, IFRS) records derivative positions on a net basis.

Q.5. Should the GAAP/IFRS difference and implications be detailed and addressed in the rulemakings? If not, why not?

A.5. The proposed rule focused on the numerical value of the supplementary leverage ratio, thereby maintaining continuity with the definition of that ratio in the revised capital rules the agencies published in July 2013. The measurement of derivatives exposure is an important issue that the agencies continue to analyze with the Basel Committee. The Basel Committee recently issued a consultative paper that proposes changes to the measure of exposure used in the international leverage ratio framework, including for derivatives. As noted in the proposed rule, if the Basel Committee finalizes changes to the leverage exposure measure, the agencies would consider the appropriateness of such changes for purposes of U.S. regulation.

Q.6. Have you compared the proposed leverage ratios to the losses experienced by banking institutions during the financial crisis?

A.6. As noted in the preamble to the proposed rule, the agencies’ analysis suggests that the 3-percent supplementary leverage ratio standard would not have materially constrained leverage had it

been in effect during the years leading up to the crisis. This suggests that the 3-percent leverage standard is an insufficient safeguard. With the proposed 6-percent supplementary leverage ratio for covered insured banks, the increase in stringency of the leverage standards for these institutions would be similar to the increase in stringency of their risk-based capital requirements in the revised capital rules published in July 2013.

Q.7. Why is there a distinction between the leverage ratio for bank holding companies and depositories?

A.7. The one percentage point difference in the proposed rule between the supplementary leverage requirements for banks and bank holding companies is structurally similar to the current generally applicable leverage requirements, which also incorporate a one percentage point difference between insured banks and bank holding companies.

Q.8. Under 12 U.S.C. 1818(e), Federal banking agencies may remove “institution-affiliated parties” from participation in the affairs of an insured depository when they directly or indirectly violate banking laws or regulations. Were officers or directors of any bank that was party to the mortgage servicer settlements removed because they directly or indirectly participated in the violations that led to the settlements? If no officer or director was removed, can you explain why?

A.8. The October 2010 announcement by Ally Financial, Inc. (AFI) (the parent of Ally Bank (Midvale, Utah), Residential Capital, LLC (ResCap) and GMAC Mortgage, LLC) that certain of its subsidiaries (ResCap and GMAC Mortgage) had engaged in certain foreclosure practices, now commonly referred to as “robo-signing,” prompted the FDIC’s review of the mortgage servicing practices and procedures of GMAC Mortgage, an affiliate of Ally Bank. The Federal Reserve Bank of Chicago joined the FDIC’s review of GMAC Mortgage. The Federal banking agencies subsequently initiated a horizontal review of the Nation’s 14 largest mortgage servicers. The Department of Justice (DOJ) and a task force of the State Attorneys General conducted a parallel review of these practices. As a result of these reviews, the Federal banking agencies entered into Consent Orders with the entities they supervised and the DOJ and State AGs entered into Consent Judgments with many of these same entities.

The FDIC is the primary Federal supervisor of Ally Bank. Ally Bank, like many other depository institutions, engages third parties to perform mortgage servicing. The horizontal review of the major servicers determined that they had engaged in unsafe and unsound mortgage servicing practices, and the FDIC determined that Ally Bank had failed to properly supervise and adequately oversee its third party servicers. Accordingly, the FDIC ordered Ally Bank to take corrective action to rectify its oversight deficiencies. The required corrective action is detailed in the Consent Order entered into by AFI, ResCap, GMAC Mortgage and Ally Bank with the Board of Governors of the Federal Reserve System and the FDIC. The effect of this Order is to require the bank to ensure that its affiliated servicer takes corrective measures to fully address the deficiencies identified in the interagency review. Both

the bank and its affiliates have made substantial progress in complying with the requirements of the Consent Order. However, the facts regarding Ally Bank and its institution affiliated parties documented during the horizontal review were not sufficient to satisfy the misconduct, effect and culpability statutory standards required to support any removal and prohibition action under Section 8(e).

Q.9. How do you audit large bank IT systems to determine potential systemic risk?

A.9. Where the FDIC is the primary Federal regulator of a large institution, FDIC examiners conduct information technology (IT) and operations risk management examinations to assess the effectiveness of a bank's IT risk identification, measurement, and mitigation practices. IT and operations risk management examinations are conducted concurrently with safety and soundness examinations. At the conclusion of an examination, the bank is assigned a composite rating that reflects the results of the IT and operations risk management evaluation (which assesses the effectiveness of the audit, management, development and acquisition, and support and delivery components). The composite rating is based on a scale of 1 to 5, with 1 representing the highest rating and least degree of supervisory concern and with 5 representing the lowest rating and highest degree of supervisory concern. The higher degree of supervisory concern, the more frequently the institution is examined. In addition to full-scope examinations, FDIC examiners may conduct interim visitations to assess whether the bank is addressing deficiencies noted in the most recent full-scope examination.

The Federal Financial Institutions Examination Council publishes an *IT Examination Handbook* that addresses topics such as Information Security, Supervision of Technology Service Providers, and Business Continuity Planning. The Handbook describes specific IT risks and includes examination procedures used to assess a bank's compliance with Federal laws, regulations, and supervisory guidance. The procedures in the Handbook are more granular for larger, more complex banks. For example, the Information Security and Business Continuity Planning examination procedures are structured as Tier I and Tier II. Tier II procedures are targeted at larger, more complex institutions and are more in-depth.

Where the FDIC is not the primary Federal regulator, FDIC examiners and specialists monitor potential risks associated with information technology systems' capabilities and controls at such firms through ongoing interaction with the primary Federal regulator and other regulators of such institutions. This ongoing interaction includes obtaining continuous feeds of supervisory findings from other regulators and internal risk reporting from the institutions as well as working on-site at the firms alongside the other regulators, including direct participation in certain supervisory reviews and activities. The FDIC also obtains information about an institution's management information systems through the review of institution-prepared resolution plans at both the consolidated level and at individual large banks within the organization. Such activities allow the FDIC to develop an independent assessment of the risk profile of such institutions and determine whether appro-

appropriate corrective actions are being taken to reduce unreasonable risk.

Q.10. The U.S. Chamber of Commerce has called for a trade review of the Volcker Rule, alleging that the rule violates trade agreements. Has your agency done any legal analysis of whether pending or prior trade pacts would vitiate its ability to impose higher capital requirements on SIFIs?

A.10. We are not aware of any trade agreements that diminish our statutory authority to impose higher capital requirements on SIFIs, either through a rulemaking or by order on a case-by-case basis. The Federal banking agencies have considerable discretion to impose capital requirements under the prompt corrective action (PCA) requirements of section 38 of the Federal Deposit Insurance Act, the International Lending Supervision Act, as well as various provisions of the Dodd-Frank Act (including sections 165 and 171). Historically, the risk-based and leverage capital requirements have served as the basis for determining an institution's capital category under PCA.

Q.11. Has your agency performed any studies or prepared any estimates of the profit subsidy banks derive from carrying derivatives in depositories?

A.11. We have not attempted to directly estimate the profit subsidy from derivatives activities in IDIs. However, the revenue generated from derivatives activities in IDIs is publicly disclosed. The following table is based on the Office of the Comptroller's latest quarterly derivatives report:

Bank Trading Revenue \$ in millions	YTD 2013	2012	2011	2010	2009	2008	2007	2006	2005
Interest Rate	4,985	16,966	15,949	6,162	14,470	1,778	8,110	4,617	4,466
Foreign Exchange	6,320	5,267	5,061	9,081	5,595	11,363	6,973	7,953	6,219
Equity	1,753	2,044	2,894	2,052	1,061	(2,016)	2,881	4,952	3,108
Commodity & Other	646	1,182	1,441	618	1,460	1,451	294	1,265	593
Credit	1,059	(6,843)	5,062	4,605	6	(13,001)	(12,704)	0	0
Total Trading Revenues	14,762	18,617	30,408	22,518	22,592	(425)	5,555	18,786	14,385

Note: Effective in the first quarter of 2007, trading revenues from credit exposures are reported separately, along with the four other types of exposures.

Note: Trading revenue is defined here as "trading revenue from cash instruments and off balance sheet derivative instruments."

Note: Numbers may not sum due to rounding.

Note: YTD 2013 is as of 2Q 2013

Source: OCC Derivative Reports, from Call Reports, Schedule RI

RESPONSES TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM THOMAS J. CURRY

Q.1. In late 2011, the agencies issued a highly complex and lengthy regulatory proposal to implement the Volcker rule. In February of this year, Chairman Bernanke testified that while regulators have made a lot of progress on the rule, the issues slowing the process "are finding agreement and closure among the different agencies" When can we expect the final rule? What are the reasons for a delay?

A.1. The agencies have targeted year-end 2013 for issuance of a final rule, and we have made considerable progress toward achieving that goal. Work on the Volcker rule has required continuing re-

view and careful analysis of the over 19,000 comments submitted during the rule-making process, drafting rule text and an explanatory preamble that addresses the substantive comments received, and regular interagency consultations to ensure the agencies' rules are comparable and provide for consistent application. The time and resources that the agencies have spent on developing a final rule reflect the complexity of the issues, the level of detail and variety in the concerns discussed by the commenters, and the care taken to consider and evaluate the approaches available to address those concerns.

Q.2. Your agencies published a short guide for smaller, less complex institutions so they can understand and implement the final Basel III rule. Both of your agencies, together with the FRB, took additional steps to analyze and mitigate the burden of the proposed rule on community banks before promulgating final rules. What steps is your agency taking to ensure that its bank examiners and regional office staff properly interpret and apply the Basel III regime for community banks versus larger banks?

A.2. In addition to the Community Bank Guide and the Quick Reference Guide, OCC is preparing a presentation to convey a consistent message on the changes most relevant to community banks. This presentation will be used in field offices throughout the country to familiarize examiners with the capital changes, support consistent interpretation and application of the rules by examiners, and to facilitate meetings with bank and thrift management in discussing the changes. The presentation will also be available on our dedicated Web site for national banks and Federal savings associations (BankNet). In addition, OCC conducts ongoing national and local outreach to discuss current topics and issues. The capital changes will be an ongoing topic in the months to come. Institutions are always encouraged to contact their local Assistant Deputy Comptroller with any questions or topics they would like to discuss and OCC Portfolio Managers conduct quarterly monitoring calls with each national bank and Federal savings association. These calls are another avenue to discuss implementation.

Finally, the final rule includes a lengthy transition period before smaller banks must comply with the new standards. All but the largest, most complex banking organizations will have until the beginning of 2015 before the first elements of the new capital framework come into effect. In addition, banks will be granted a lengthy phase-in period such that all elements of the new framework will not be in place until 2019.

**RESPONSES TO WRITTEN QUESTIONS OF
SENATOR MENENDEZ FROM THOMAS J. CURRY**

Q.1. Over the last few months, we've seen reports in the press of so-called "regulatory capital trades", in which regulated financial institutions have purchased credit protection (often using credit default swaps) from unregulated entities (often SPVs, hedge funds, or other entities formed offshore to avoid regulation) in order to reduce the amount of capital they need to hold against an investment on their books. In effect, these trades are transferring risk from regulated institutions that are subject to capital requirements to

unregulated entities that are not subject to capital requirements, and creating exposure of the regulated institution to a potential default by the unregulated entity.

If this story sounds familiar, it should—this is strikingly similar to what we saw happen with AIG before the financial crisis. These trades are transferring risk from regulated and supervised financial institutions to unregulated corners of the market, where it can build and concentrate without monitoring or supervision by regulators.

The Basel Committee has partly addressed this issue by calling for banks to properly account in their capital calculations for the costs of credit protection they purchase. But does this proposal do enough to address concerns about regulatory arbitrage and systemic risk accumulating all over again through “shadow banking”? Are you concerned about these “regulatory capital trades”, and what steps are you taking to monitor and address these arrangements?

A.1. We believe that concerns with the types of trades you describe have been reduced for a number of reasons, reflecting lessons learned from the recent financial crisis. The OCC carefully scrutinizes the credit risk transfer transactions from a supervisory perspective and limits the ability of banks to recognize regulatory capital benefits from such transactions unless risks have truly been transferred to a third party. In addition, risk transfer transactions with nonbanks are now almost always collateralized by cash posted by the counterparty dealer or nonbank investor. These counterparties have real money at risk, which helps to ensure that the end-investor bears the actual risks of any losses, and makes it less likely that the risks will flow back to the banking system or lead to contagion concerns. In the absence of cash or other high-quality collateral, our standards require banks to hold more capital. The application of the proposed swap margin rules, which would require financial counterparties to credit derivative transactions to post both initial and variation margin, would further reduce the risk of nonperformance of protection providers, thereby further ensuring that these transactions legitimately transfer risk.

Q.2. I held a hearing earlier this year in the Housing Subcommittee examining the botched independent foreclosure review process and related settlement. At the time, the GAO issued a report that looked at some of the problems that occurred and outlined a set of “lessons learned.” In particular, the GAO recommended that the OCC and the Fed improve oversight of sampling and consistency, apply lessons in planning and monitoring to activities under the consent order and continuing reviews, and implement a communication strategy to keep stakeholders informed. I’m concerned, however, by recent reports suggesting that some of the same problems we saw before are continuing to occur. Are you familiar with the GAO’s recommendations, and what steps has the OCC taken to implement them? In your own reviews of the process, what other changes have you identified and made?

A.2. The OCC received the GAO’s draft report on March 13, 2013. As I described in a letter to the Committee on Homeland Security and Governmental Affairs Ranking Member Coburn dated June 7,

2013, the OCC has the following actions underway in response to the recommendations in the GAO report.

First, to improve oversight of sampling methodologies and mechanisms to centrally monitor consistency in the remaining foreclosure reviews, our examination and economics staff have been working closely with the independent consultants engaged in the remaining reviews to ensure sampling approaches are consistent and conform to OCC guidance. Second, we have identified and applied lessons from the foreclosure review process—such as enhancing planning and monitoring activities to achieve goals—to our activities under the amended consent orders. We enhanced our centralized planning, monitoring and tracking of activities associated with the amended consent orders to help ensure we meet our goals in a timely and consistent manner. For example, we put into place an expanded post-settlement foreclosure consent order project plan, and we created an examination plan each resident team will use to test compliance with all articles of the consent orders. Goal-oriented results are reported to me and other OCC senior management weekly. Finally, GAO recommended that we implement a communication strategy to keep stakeholders informed. We are following a communication strategy that makes use of methods we have found to be most effective with various audiences—direct outreach to affected borrowers, webinars for counselors and consumer groups, and updates to our Web site. We publish weekly updates on our Web site on the number of borrowers who have cashed or deposited checks and other news on the independent foreclosure review. Through these updates, we have also issued reminders to borrowers on the process for presenting checks and we have provided notice to financial institutions on the process for validating and accepting checks. We are currently planning the content and timing of additional public reports to inform stakeholders about the IFR Payment Agreements, the status of reviews for servicers who did not join the agreements, and servicer compliance with other articles of the original foreclosure-related consent orders.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BROWN FROM THOMAS J. CURRY

Q.1. A critical element of the proposed new Basel leverage ratio is the definition of the denominator (the assets subject to the leverage requirement). A denominator definition that permits too many bank commitments to remain off the balance sheet and uncapitalized could undermine the benefits of a higher leverage ratio requirement.

Have the banking agencies made a quantitative examination of the change in bank assets subject to the leverage requirement that will be created by the new Basel leverage rules?

A.1. The Basel III supplementary leverage ratio (Basel leverage ratio) uses a much more inclusive definition of exposure than does the existing generally applicable leverage ratio denominator. Specifically, unlike the current generally applicable leverage ratio, which ignores all off-balance sheet exposures, the Basel leverage ratio, in most cases, includes the full notional amount of such exposures (for example, most loan commitments and letters of credit).

Based on the agencies' analysis in the leverage ratio proposed rule, the denominator of the Basel leverage ratio, on average, is roughly 40 percent greater than the current generally applicable leverage ratio. This analysis is based on a group of the largest U.S. banks as of the third quarter of 2012.

Q.2. Could you please inform us, for the six largest U.S. banks and bank holding companies, the approximate amount of total assets that would be counted for the denominator of leverage capital requirements under the following definitions of assets: U.S. GAAP, IFRS accounting, and the proposed Basel leverage ratio definition.

A.2. U.S. GAAP—The Basel III framework attempts to account for differences between IFRS and U.S. GAAP for purposes of calculating the Basel leverage ratio. As a result, the denominator of the ratio (i.e., the measure of exposure amount) is fairly independent of the accounting regime that a bank uses for reporting purposes. See the table below for a comparison of assets as measured by GAAP and the estimated exposure that would be used for the Basel leverage ratio for the six largest U.S. bank holding companies, in aggregate.

IFRS accounting—U.S. bank holding companies do not report, on a consolidated basis, under an IFRS accounting framework and therefore, such data are not readily available. As noted earlier, the balance sheet total assets figure under IFRS is not being used as the denominator for the Basel leverage ratio.

The proposed Basel leverage ratio definition—The table below provides a comparison of GAAP total assets and estimates of the total exposure, as reported in the Comprehensive Capital Analysis and Review for the third quarter of 2012, for the six largest U.S. bank holding companies.

GAAP Assets (Millions)	Exposure Estimate (Millions)	\$ Difference	% Increase
9,527,828	13,280,381	3,752,553	39.4

Q.3. What factors are most important in determining the difference between GAAP and IFRS accounting and the proposed Basel leverage ratio definition? What is the total amount of the difference accounted for by: Changes in off-balance sheet treatment of credit commitments that are not derivatives contracts and changes in derivatives netting and offset rules.

To the degree possible, please include breakdowns of the impact of the relevant sub-changes in each of these areas, as well as written explanations of the areas in the Basel leverage ratio definition that account for the differences.

A.3. For financial reporting purposes, there can be significant differences between the total assets of an entity calculated under U.S. GAAP and IFRS. Specifically, the offsetting requirements (i.e., when a reporting entity has the right to offset the value of a financial asset with the value of a financial liability in the statement of

financial position) account for the single largest quantitative difference between statements of financial position prepared under U.S. GAAP and under IFRS. Under IFRS, an entity can only offset a financial asset and a financial liability when there is both an unconditional right of offset and an intention to settle net. Under U.S. GAAP, entities are allowed to offset derivatives, as well as related cash collateral, and certain repurchase agreement balances subject to master netting agreements, including when net settlement is contingent upon default or is not intended. There are also minor quantitative differences due to the treatment of off-balance sheet commitments under the different accounting regimes.

In developing the Basel leverage ratio, the Basel Committee recognized the important accounting differences, particularly with respect to the treatment of derivatives, and employed an approach to neutralize accounting differences within the Basel leverage ratio. As a result, the denominator of the Basel leverage ratio is calculated under a regulatory framework, minimizing the impact of a reporting entity's accounting regime. Although a side-by-side comparison has not been performed for the calculation of the total exposure of the six largest U.S. banks under U.S. GAAP, IFRS, and the Basel leverage ratio definition (due to the fact that U.S. institutions do not report under IFRS), qualitatively, the Basel leverage ratio allows for more lenient netting rules than IFRS but stricter netting than U.S. GAAP. Therefore, it could be expected that the total exposure under the Basel leverage ratio would be somewhere between the two but closer to a U.S. GAAP amount. The Basel Committee is continuing to refine the Basel leverage ratio definition and recently issued a consultative paper on further enhancements.¹

Q.4. The new leverage ratio proposals mandate a leverage ratio of 6 percent for large bank subsidiaries, but a lower 5-percent ratio for the overall holding company. What policy justification is there for this distinction between the bank and the holding company?

A.4. This dichotomy arises because Prompt Corrective Action (PCA) requirements, and therefore well-capitalized standards under PCA, apply only at the bank level, and not at the holding company level.

The proposal is structurally consistent with the current relationship between the generally applicable leverage ratio requirements for banks and holding companies under existing regulatory standards. Under existing capital standards, all banks must maintain a 5-percent generally applicable leverage ratio to be well capitalized for PCA purposes, whereas holding companies must maintain a minimum 4-percent generally applicable leverage ratio.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR WARREN FROM THOMAS J. CURRY

Q.1. Has your agency done any studies on the costs and benefits of allowing banks to book derivatives in depositories?

A.1. The OCC has not conducted a formal, comprehensive, "cost benefit analysis" of allowing banks to book derivatives in depository-

¹"Revised Basel III Leverage Ratio Framework and Disclosure Requirements", at <http://www.bis.org/press/p130626.htm>.

tories. However, the OCC has assessed, and made public, the risks and rewards of trading activities, including those involving derivatives, since 1995 through the OCC's "Quarterly Report on Bank Trading and Derivatives Activities". Further, a qualitative assessment of costs and benefits is an integral part of the OCC's consideration of the legal permissibility of new derivatives products. Moreover, the OCC is currently reviewing, as required under Section 620 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the types of derivatives activities permissible for national banks and their associated risks. Finally, the OCC observes that there is a positive correlation between loan loss provisions and trading revenues (much of which is in derivatives) at the largest trading banks. This means that when loss provisions are high, and therefore bank earnings are under pressure, trading revenues also tend to be high. That positive relationship between provisions and trading revenues helps to diversify the net income of these largest firms.

Q.2. A number of derivatives experts, including Frank Partnoy and Satyajit Das, contend that a large percentage of complex OTC derivatives, including credit default swaps, are not used for commerce but for economically unproductive activities such as gaming accounting and tax rules or hiding losses. Have you ever taken a large sample of derivatives transactions to see if these charges have validity? If the charges are accurate, in what ways would you change your views about derivatives regulation?

A.2. Examiners in the large dealer banks do routinely perform transaction testing of complex derivatives trades to assess compliance with the interagency guidance on Complex Structured Finance Transactions (CSFTs).¹ They typically select transactions for testing based on a review of transaction summaries and selecting those that appear to indicate the higher risks addressed in the CSFT guidance.

The CSFT guidance cautions banks that if due diligence efforts indicate that participation in a particular CSFT would create significant legal or reputational risks, bank management should take steps to address those risks. Such steps may include either declining to participate in the transaction, or conditioning its participation upon the receipt of representations or assurances from the customer that reasonably address the heightened legal or reputational risks presented by the transaction. If the bank determines that a transaction presents unacceptable risk, or would result in a violation of applicable laws, regulations, or accounting principles, the bank should decline to participate in the transaction.

Examples of CSFTs that often pose elevated risks and thus covered by the CSFT guidance include transactions that:

- Lack economic substance or business purpose;
- Are designed or used primarily for questionable accounting, regulatory, or tax objectives, particularly when the transactions are executed at year-end or at the end of a reporting period for the customer;

¹ OCC Bulletin 2007-1, January 5, 2007.

- Raise concerns that the client will report or disclose the transaction in its public filings or financial statements in a manner that is materially misleading or inconsistent with the substance of the transaction or with applicable regulatory or accounting requirements;
- Involve circular transfers of risk (either between the financial institution and the customer or between the customer and other related parties) that lack economic substance or business purpose;
- Involve oral or undocumented agreements that, when taken into account, would have a material impact on the regulatory, tax, or accounting treatment of the related transaction, or the client's disclosure obligations;
- Have material economic terms that are inconsistent with market norms (e.g., deep "in the money" options or historic rate rollovers); or
- Provide the financial institution with compensation that appears substantially disproportionate to the services provided or investment made by the financial institution or to the credit, market, or operational risk assumed by the institution.

Field examiners performing CSFT reviews specifically inquire about trade purpose. They report that the purpose of most complex transactions is either to lock in a profit, hedge a risk, or make an investment. Further transactional testing, which examiners perform to test compliance with the CSFT guidance, has not revealed that a large percentage of complex OTC derivatives involve gaming accounting and tax rules or hiding losses. With respect to tax issues, it is common for banks to require tax department personnel to approve all CSFTs as part of any complex/nonstandard trade or new product approval. This procedure ensures that individuals with appropriate tax knowledge and sensitivity to reputation risk issues are comfortable with the bank's assumption of higher risks on these transactions.

Q.3. Treasury Lew recently stated, "if we get to the end of this year and we cannot with an honest straight face say that we have ended Too Big To Fail, we're going to have to look at other options." Do you agree?

A.3. I agree with the Secretary and others that we need to end the perception that some financial institutions are "too big to fail." I also believe that the significant financial and structural reforms that the Dodd-Frank Act and the regulators are putting into place will significantly enhance the resiliency of large financial institutions and, should they develop problems, provide mechanisms to resolve them in an orderly manner without expense to the American taxpayer. These actions, which I discussed more fully in my written statement, include:

- Significantly tougher capital requirements that raise both the level and quality of capital large banking organizations must hold. The revised capital standards that we recently issued increase both the quantity and quality of capital necessary to meet minimum regulatory requirements and enhance the minimum leverage ratio requirements for the largest banks. The

rule also mandates that all institutions maintain a buffer of additional common equity, and restricts payment of dividends and bonuses if that buffer falls below 2.5 percent. In addition, for large banks and thrifts, the rule established a countercyclical buffer that can be activated during upswings in the credit cycle to protect against excessive lending. A forthcoming rulemaking will propose a so-called “SIFI-surcharge” that would apply to the largest, most systemically important financial institutions. With these additional requirements, the largest U.S. banks could be required to hold Tier 1 common equity equal to as much as 12 percent of their risk-adjusted assets during upswings in the credit cycle.

To further strengthen the capital base of systemically important financial institutions and to provide additional safeguards against excessive leverage at those firms, the OCC, the Federal Reserve Board and the FDIC also recently issued a proposed rulemaking that would substantially increase their minimum supplemental leverage ratio requirements. A higher supplemental leverage requirement will place additional private capital at risk before the Federal deposit insurance fund and the Federal Government’s resolution mechanisms would be called upon, and reduce the likelihood of economic disruptions caused by problems at these institutions. By providing a larger capital cushion, it would reduce the likelihood of resolutions, and would allow regulators more time to tailor resolution efforts in the event those are needed.

- Explicit liquidity requirements on the amount of short- and longer-term liquid assets that the largest banks must hold to cover potential outflows and to fund their balance sheet structure. As noted in my written statement, the Basel Committee’s Liquidity Framework introduces two explicit minimum liquidity ratios—the Liquidity Coverage Ratio and the Net Stable Funding Ratio—to help ensure banking organizations maintain sufficient liquidity during periods of financial stress. The OCC, Federal Reserve, and FDIC are developing a proposed rule to implement the Liquidity Coverage Ratio in the U.S. for large banking organizations, which we hope to issue for comment by the end of this year.
- Heightened expectations for stronger corporate governance and more stringent risk management. At the OCC, we’ve told the large banks we oversee that we are holding them to a higher standard than other banks and will insist that their entire risk management regime—from the culture at the top, to all of their systems—be strong. Our efforts for strong corporate governance and risk management complement and reinforce the heightened prudential standards that Dodd-Frank mandated for banks over \$50 billion and that the FRB is implementing. Moreover, I have instructed my staff to develop an approach for incorporating our heightened expectations into our rulebook. This would formalize our standards and enhance our toolkit for applying and enforcing them.
- Dodd-Frank Resolution Authorities. The orderly resolution provisions of Dodd-Frank and the creation of FSOC provide impor-

tant new mechanisms for regulatory coordination and for resolving large institutions. The living wills process will provide an important mechanism for the regulators to assess whether the various legal structures used by the largest banks are an impediment for effective supervision and, if needed orderly resolution. Likewise, the Orderly Liquidation Authority under Title II provides the FDIC with tools to use when resolving systemically important financial institutions while minimizing moral hazard.

Other provisions of Dodd-Frank will fundamentally alter how and where various financial activities and risk taking can be conducted—chief among these are the Volcker rule prohibitions on proprietary trading, the risk retention rules that will require bank securitizers to have “skin in the game,” the swap margin and central counterparty and clearing provisions, and the incentive compensation rules.

Combined, these represent profound and far sweeping regulatory changes that should significantly enhance the overall resiliency of our financial system. I believe we need to fully implement these changes before we start to alter the regime set forth in Dodd-Frank.

Q.4. The agencies have proposed increasing the leverage ratio for very large bank holding companies to 5 percent, and for depositories to 6 percent. These “supplementary” ratios are calculated using U.S. GAAP accounting measures. This means that total on-balance-sheet assets include only the net value of derivatives positions. If derivatives were accounted for under IFRS, which limits derivatives netting, then their total assets would be substantially higher. (*See, for example, the analysis of the quantitative impact of different accounting rules done by ISDA: at <http://www2.isda.org/functional-areas/research/studies/>.*)

Does the proposed increase in the leverage ratio do more than bring the U.S. leverage requirement roughly into line with the 3-percent leverage ratio that will be applied by EU regulators to all banks?

A.4. Yes. The proposed Basel leverage ratio levels would use the same metric applied internationally at a 3-percent level and would apply higher requirements for the largest banks to be considered well capitalized under Prompt Corrective Action and for their holding companies to avoid capital distribution constraints.

The Basel leverage ratio was developed with the understanding that accounting regimes vary greatly in their degree of asset recognition. The measure attempts to neutralize these differences by placing all banks, regardless of the accounting regime under which they report, onto a level playing field. Therefore, the accounting differences under U.S. GAAP and IFRS were not the motivating factor for proposing higher Basel leverage ratio levels for the largest U.S. institutions. Rather, the motivation was to enhance the safety and soundness of these institutions and to ensure that the relative calibration of the Basel leverage ratio is aligned with the higher risk-based ratios that are part of the recently finalized regulatory capital rules.

While the proposed Basel leverage ratio levels are above the agreed-upon international standards, applying higher standards to U.S. institutions is consistent with Basel standards, which are intended to serve as minimum requirements. Several other countries have also proposed or implemented higher capital standards than those agreed to under the Basel III framework.

Q.5. Should the GAAP/IFRS difference and implications be detailed and addressed in the rulemakings? If not, why not?

A.5. As noted above, the calculation of the Basel leverage ratio is designed to be largely independent of the accounting regime a bank uses. In other words, the Basel leverage ratio should be largely independent of whether a bank is using a U.S. GAAP-based or IFRS-based accounting regime. Therefore, the need to address differences between U.S. GAAP and IFRS is minimized.

Q.6. Have you compared the proposed leverage ratios to the losses experienced by banking institutions during the financial crisis?

A.6. We have compared the stringency of the leverage ratio requirement to the stressed environment banks experienced from the financial crisis. An estimated one-half of the covered bank holding companies would have met or exceeded a 3-percent minimum supplementary leverage ratio at the end of 2006, and the other half were quite close to the minimum. This suggests that a minimum requirement of 3 percent would not have placed a significant constraint on the precrisis buildup of leverage. Based on experience during the financial crisis, the agencies believe that there could be benefits to financial stability and reduced costs to the deposit insurance fund by requiring these banking organizations to meet a well-capitalized standard or capital buffer in addition to the 3-percent minimum supplementary leverage ratio requirement and is a primary reason why we have proposed such a higher standard for the largest institutions.

We considered many other factors in calibrating the enhanced supplementary leverage ratio standards, including the complementary nature of leverage capital requirements and risk-based capital requirements as well as the potential complexity and burden of additional leverage standards. We also think it is important that leverage capital requirements are not viewed in isolation. From a safety-and-soundness perspective, each type of requirement-leverage and risk-based-offsets potential weaknesses of the other, and the two sets of requirements working together are more effective than either would be in isolation. In this regard, the proposal more closely aligns the stringency of the leverage and risk-based standards so that neither ratio is binding at all times. Closely aligned standards not only minimize the degree to which banks can actively manage risk-weighted assets before they would breach the leverage requirements, but also minimize the incentive for banks to take on additional risk before they would breach risk-weighted requirements. Finally, in weighing the burden of imposing higher leverage standards against the benefits to financial stability the agencies considered the potential effects on credit availability. The agencies are seeking comment on all aspects of the proposal, including the proposed calibration of the leverage standards.

Q.7. Why is there a distinction between the leverage ratio for bank holding companies and depositories?

A.7. This dichotomy arises because Prompt Corrective Action (PCA) requirements, and therefore well-capitalized standards under PCA, apply only at the bank level, and not at the holding company level.

The proposal is structurally consistent with the current relationship between the generally applicable leverage ratio requirements for banks and holding companies under existing regulatory standards. Under existing capital standards, all banks must maintain a 5-percent generally applicable leverage ratio to be well capitalized for PCA purposes, whereas holding companies must maintain a minimum 4-percent generally applicable leverage ratio.

Q.8. Under 12 U.S.C. 1818(e), Federal banking agencies may remove “institution-affiliated parties” from participation in the affairs of an insured depository when they directly or indirectly violate banking laws or regulations. Were officers or directors of any bank that was party to the mortgage servicer settlements removed because they directly or indirectly participated in the violations that led to the settlements? If no officer or director was removed, can you explain why?

A.8. No officers or directors of the participating servicers have been removed pursuant to 12 U.S.C. 1818(e). The amendments to the foreclosure consent orders do not provide for any release of OCC enforcement actions against officers, directors and/or employees of the servicers that were parties to the mortgage servicer settlements. The OCC considers enforcement actions against individuals and where there is evidence of individual wrongdoing that meets the legal standards under 1818(e), removal and prohibition actions are pursued.

Q.9. How do you audit large bank IT systems to determine potential systemic risk?

A.9. The OCC examines large bank IT systems as part of regular, ongoing examination activities to determine potential systemic risk. This enables the OCC to maintain an ongoing program of risk assessment, monitoring, and communications with bank management and directors. Examiners assigned to large institutions include Bank Information Technology (BIT) examiners with a thorough knowledge and understanding of BIT risks, examination activities, emerging technologies, industry-effective practices, BIT-related laws, regulations, and guidance.

BIT examiners focus on risk issues inherent in automated information systems, including: management of technology resources (whether in-house or outsourced); integrity of automated information (i.e., reliability of data and protection from unauthorized change); availability of automated information (i.e., adequacy of business resumption and contingency planning); and confidentiality of information (i.e., protection from accidental or inadvertent disclosure). BIT examiners assess institutions against standards and guidelines established in FFIEC and OCC handbooks and issuances, as well as applicable laws and regulations.

Risk issues identified through examination activities are evaluated as potential systemic risks. The OCC assesses the systemic nature of identified risk issues through multiple forums and com-

munication channels. Depending on the nature of the risk issue, examiners communicate and discuss the risk issues with Examiners-in-Charge, examiners in other disciplines, peer network groups, large bank lead experts, OCC senior management, OCC policy staff and/or other regulatory agencies.

Q.10. The U.S. Chamber of Commerce has called for a trade review of the Volcker Rule, alleging that the rule violates trade agreements. Has your agency done any legal analysis of whether pending or prior trade pacts would vitiate its ability to impose higher capital requirements on SIFIs?

A.10. The question is best directed to the Federal Reserve Board, which has authority to impose capital requirements on SIFIs. SIFIs are BHCs with \$50 billion or more in total assets and nonbank companies designated by the FSOC. The OCC lacks the authority to impose capital requirements on such entities.

Q.11. Certain aspects of the U.S. payments system lag international standards by a substantial margin. For example, the U.S. still uses magnetic strip technology for credit and debit cards, while in Europe, Asia, and even emerging markets like South Africa, more secure chip cards (smart cards) have been widely used since the late 1990s. South Africa has also used cards for paying unbanked laborers starting in the 1990s, and at much lower fee levels than American banks charge. Can you explain how a less advanced country with much smaller banks can run an apparently more efficient payment system than the United States?

A.11. The U.S. payments system is a complex ecosystem. Cards are only one of the vehicles used for making payments and technology is constantly evolving to introduce new forms of payment services. For example, both banks and technology companies are introducing mobile payment systems that allow payments to be delivered and authenticated via mobile devices. Technologies exist that allow small businesses to accept existing magnetic strip cards with their mobile phones or tablets. In addition, consumers can read and store Quick Response (QR) codes² on their mobile phones for payments. It is unclear what technology will dominate in the future, and like today, many may coexist.

The card world itself is a multilayered environment comprised of banks that are issuers, bankcard companies, bank and nonbank processors and acquirers, and retailers. Most of the U.S. card market was developed around the magnetic strip technology. Banks can and do issue smart cards to consumers and corporate clients—primarily for frequent travelers, but for this technology to be fully functional, other changes are needed: ATMs must be equipped to accept the embedded computer chip in the “smart cards” and merchants must have point of sale (POS) devices that will accept the cards. Independent sales organizations, merchants, and banks must work together to ensure that all the necessary hardware functions with the new cards.

The major credit card companies are taking steps to facilitate the migration to “smart cards.” Specifically, Visa, MasterCard, Amer-

²A two-dimensional bar code that is widely used to provide easy access to information through a smart phone.

ican Express, and Discover plan to phase in smart cards that use EMV (Eurocard, MasterCard, Visa) technology in the U.S. market over the next few years. The EMV migration plans all have similar incentives and timelines designed to encourage migration by processors, acquirers, and retailers by October 2015. In the interim, we fully expect that these two technologies will coexist. Bankcard companies are eager to adopt EMV technology because of the reduction in fraud at the POS. However, EMV does not solve all fraud and security-related issues. For example, these standards do not prevent “card not present” fraud. In addition, EMV has been “broken.” British researchers from Cambridge University cracked the card in 2012, claiming that fraudsters can penetrate EMV chip cards through certain ATMs and payment terminals.³

Fees associated with payment technologies are affected by centralization, Government involvement, and regulation, as well as the complexity of the payments ecosystem such that looking at a single fee can be misleading. In many emerging Nations, the financial infrastructure is just being developed and thus can rely on newer and less costly (nonpaper intensive) technologies versus more established systems such as the U.S. where a variety of technologies must be supported. As a result, the fee structures for banks operating in those countries do not need to support a more complex ecosystem. In many less developed countries Government support and sponsorship of organizations like the mobile network operators also have helped reduce the cost to the consumer. In fact, U.S. bankcard companies are working with foreign Governments to develop their payment systems and therefore lessen the cost of development within those countries.

³A loose thread in the technology’s standard gives them an opening, according to these researchers. As part of the EMV standard, ATMs or payment terminals must provide an authentication number that is nonrepeating. However, some machines provide numbers that simply increase by the same amount for every transaction. That could allow hackers to predict an authentication number, steal the card’s information, and create a cloned card, the report said.